S. HRG. 98-69

ADMINISTRATION'S FISCAL YEAR 1984 BUDGET PROPOSALS

HEARING

BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

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ADMINISTRATION'S FISCAL YEAR 1984 BUDGET PROPOSALS

THURSDAY, FEBRUARY 3, 1983

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Robert Dole (chairman) presiding.

Present: Senators Dole (presiding), Danforth, Chafee, Heinz, Wallop, Bentsen, Baucus, Bradley, Mitchell, Boren, and Pryor.

[The press release announcing this hearing and a summary of the administration revenue proposals follow:]

Press Release No. 83-104

PRESS RELEASE

FOR IMMEDIATE RELEASE
January 21, 1983

UNITED STATES SENATE
COMMITTEE ON FINANCE
SD-221 Dirksen Senate Office Building

FINANCE COMMITTEE SETS HEARING ON ADMINISTRATION'S BUDGET PROPOSALS

Chairman Robert J. Dole, (R., Kans.) announced today that the Senate Finance Committee will hold a hearing on Thursday, February 3, 1983 on the Administration's fiscal year 1984 budget. The Honorable Donald T. Regan, Secretary of the Treasury will testify for the Administration.

In announcing the hearing, Senator Dole stated, "We look forward to receiving the President's budget requests and to working with Secretary Regan and the Administration to bring down projected budget deficits. This hearing will provide an opportunity for the Administration to present its budget options, and is an important first step in Senate consideration of the budget."

The Finance Committee will schedule public witness hearings on the Administration's budget proposals at a later date.

The hearing will commence at 10:00 a.m. in Room SD-215 (formerly 2221) of the Dirksen Senate Office Building.

P.R. #83-104

SUMMARY OF ADMINISTRATION'S

REVENUE PROPOSALS

IN THE

FISCAL YEAR 1984 BUDGET PROPOSAL

Prepared by the

Staff of the Joint Committee on Taxation

February 2, 1983

JCX-2-83

INTRODUCTION

This document, prepared by the staff of the Joint Committee on Taxation, provides a summary of the Administration's revenue proposals made in the Fiscal Year 1984 Budget, submitted to the Congress on January 31, 1983. The Senate Committee on Finance has scheduled a public hearing on the Administration's budget proposal on February 3, 1983.

The first part of the document is an overview of the Administration's revenue proposals. The second part is a brief summary of the budget proposal. The third part is a summary of the revenue proposals, including present law and a reference to prior Congressional action (if any) on the topic. Finally, the fourth part presents the Administration's estimates of the revenue effect of their proposals.

The staff summary is based upon information available from the Fiscal Year 1984 Budget and from the Treasury Department's "Fact Sheet" with respect to the revenue proposals.

I. OVERVIEW OF ADMINISTRATION'S REVENUE PROPOSALS

The Administration's fiscal year 1984 budget document includes several revenue-related proposals.

Revenue increase items

The Administration's budget includes three general revenue increases:

(1) Social security-related tax proposals--social security tax acceleration, expanded coverage, taxation of a portion of social security benefits, and revision of the self-employment tax;

(2) Limitation on the exclusion for employer-provided health insurance premiums (i.e., inclusion of part of such premiums in taxable income and in the social security tax base); and

(3) Contingency tax increases beginning in fiscal year 1986--an excise tax on crude oil, domestic and imported, and an income tax surcharge, to be imposed only under certain budgetary and economic conditions.

The Administration estimates that these revenue-increase proposals will raise about $10.5 billion in fiscal year 1984, $10.2 billion in fiscal year 1985, and $60.9 billion in fiscal year 1986 (including the contingency taxes).

Revenue reduction items

The Administration's budget also includes proposals involving revenue reductions in five areas:

(1) Tax exclusion for interest and dividends earned on amounts deposited in qualified education savings accounts, with a phaseout of the exclusion for taxpayers with adjusted gross income (AGI) of $40,000-$60,000;

(2) Nonrefundable tuition tax credit, also with a phaseout of the credit for taxpayers with AGI of $40,000-$60,000;

(3) Caribbean Basin Initiative--(a) transfer of rum excise tax payments to Puerto Rico and the Virgin Islands, and (b) business expense deductions for attending conventions held in certain Caribbean countries;

(4) Enterprise zone tax incentives--including capital gains exemption on certain qualified property, tax credits for employees and employers, increase in regular investment tax credit, a new investment tax credit for new construction and reconstruction of buildings, and continued tax-exempt bond financing beyond the current 1986 sunset date for small issue bonds; and

(5) A temporary jobs tax credit for the long-term unemployed.

The Administration estimates that these revenue reduction proposals will reduce budget receipts by about $0.6 billion in fiscal year 1984, $1.2 billion in fiscal year 1985, and $2 billion in fiscal year 1986.

User fees/PBGC premiums

User fees.--The Administration's budget also includes various proposed user fees (new and increased fees) that are not treated as budget receipt items in the budget, but rather are treated as expenditure offsets for the particular Departmental budget (e.g., Coast Guard fees, deep water port fees, Corps of Engineers fees, cotton and tobacco market fees, etc.) The user fee proposals are not described in this summary document.

PBGC premiums.--In addition, the Administration's budget includes a request to increase the premiums paid to the Pension Benefit Guaranty Corporation (PBGC) for single-employer plans to a level that would be sufficient to cover both current and projected claims. These premium amounts are treated as expenditure offsets in the budget. The PBGC premium proposal is not described in this document.

Other revenue-related item

The Administration's budget also includes a proposal for an increase in the Civil Service employee retirement contribution, which is included in the budget as a revenue (non-tax) item. (See the revenue table in Part III of this document.) This proposal is not described in this document.

II. SUMMARY OF ADMINISTRATION'S BUDGET PROPOSAL

A. Budget Receipts and Outlays

Total budget outlays in fiscal year 1984 are estimated to be $848.5 billion, an increase of about 5 percent over the $805.2 billion of outlays estimated for 1983. As shown in Table 1, budget outlays are expected to be 24.3 percent of the gross national product (GNP) in 1984, declining to 24.1 percent in 1985, and to 23.9 percent of GNP in 1986.

Table 1

Budget Receipts and Outlays, Fiscal Years 1982-86
(Dollar amounts in billions)

Fiscal year	GNP	Receipts		Outlays		Deficit	
		Amount	% GNP	Amount	% GNP	Amount	% GNP
1982	3033.0	617.8	20.4	728.4	24.0	110.7	3.6
1983*	3193.7	597.5	18.7	805.2	25.2	207.7	6.5
1984*	3488.7	659.7	18.9	848.5	24.3	188.8	5.4
1985*	3806.7	724.3	19.0	918.5	24.1	194.2	5.1
1986*	4144.6	841.9	20.3	989.6	23.9	147.7	3.6

*Estimate

The 24.3 percent of GNP estimated to be spent by the Federal Government in 1984 is significantly less than the 25.2 percent estimated for 1983, although government outlays remain high by historical standards. These estimates do not include the outlays of off-budget Federal entities which are projected to decline dramatically from $17.3 billion in 1982 to $9.4 billion in 1986. These projected outlays include the effects of the 6-month freeze in the cost-of-living adjustment recommended in the social security plan, a proposed $55 billion in defense savings, and specific cuts or freezes in entitlement and certain discretionary programs.

Total Federal receipts in fiscal year 1984 are estimated to be $659.7 billion, an increase of about 10 percent from the $597.5 billion estimated for 1983. As shown in Table 1, receipts are estimated at 18.9 percent of GNP in 1984, rising gradually to

19.0 percent in 1985, and to 20.3 percent in 1986. Although Federal receipts are expected to rise, as a percent of GNP, over the 1983-1986 period, the Federal Government's claim on national income will not rise above the 1981 peak of 20.9 percent. These receipt estimates take into account the tax cuts put into place by the Economic Recovery Tax Act of 1981, the revenue gains provided in the Tax Equity and Fiscal Responsibility Act of 1982, the increase in Highway Trust Fund revenues arising from the Highway Revenue Act of 1982, the proposed social security plan, and the contingency tax proposal. As shown in Table 2, the net of effect of the three major tax laws enacted in 1981-82 is a reduction in tax receipts of $35.6 billion in 1982, rising to $88.2 billion in 1984, and to $146.3 billion in 1986.

Table 2

Net Effect of Major Tax Legislation Enacted in 1981-82[1]
(Fiscal years; billions of dollars)

	1982	1983	1984	1985	1986	1982-1986
ERTA of 1981	-35.6	-82.6	-130.3	-158.2	-202.3	-609.0
TEFRA of 1982	*	17.3	38.3	42.2	52.1	149.9
Highway Rev Act of 1982	--	1.7	3.8	3.9	3.9	13.2
Net tax reduction	-35.6	-63.5	-88.2	-112.1	-146.3	-445.9

[1] *$50 million or less.
These estimates are based on the direct effect only of legislative changes at a given level of economic activity. Induced effects are taken into account for forecasting incomes, however, and in this way affect the receipts estimates by major source and in total.

The Federal deficit in fiscal year 1984 is estimated to be $188.8 billion, a decrease of 9 percent from the $207.7 billion estimated for 1983. As shown in Table 1, the deficit is projected to be 5.4 percent of GNP in 1984, narrowing to 5.1 percent in 1985, and to 3.6 percent in 1986. Deficits in the range of 5 percent of GNP are quite high by historical standards, but are significantly lower than the record 6.5 percent deficit estimated for 1983. Moreover these deficits cannot be attributed to adverse cyclical conditions. The Administration estimates that the major portion of the out-year deficits is structural, and, consequently, will persist even if high employment is attained.

The annual growth rate of budget outlays over the 1982-1986 period is estimated to be 8 percent. As shown in Table 3, the fastest growing part of the budget is national defense which rises, at an annual rate of 14.6 percent, from 25.7 percent to 32.6 percent of budget outlays in this period. Payments to individuals rise at 6.8 percent per year, and decline from 47.9 percent to 45.8 percent of total outlays.

Table 3

Composition of Federal Budget Outlays, Fiscal Years 1982-86
(Percent of Total Budget Outlays)

Fiscal year	National Defense	Payments to individuals	Net interest	Other	Total
1982	25.7	47.9	11.6	14.8	100.0
1983*	26.7	48.7	11.0	13.6	100.0
1984*	28.9	47.3	12.2	11.7	100.0
1985*	31.1	46.3	12.4	10.2	100.0
1986*	32.6	45.8	12.4	9.1	100.0
Annual growth rate	14.6	6.8	9.7	-4.3	8.0

*Estimate

The annual growth rate of budget receipts over the 1982-1984 period is estimated to be 3.3 percent. As shown in Table 4, the fastest growing source of Federal receipts is social insurance taxes and contributions which rises, at an annual rate of 9.8 percent, from 32.6 percent to 36.8 percent of total receipts in this period. Excise taxes (including the Windfall Profits Tax) also rise as a proportion of Federal receipts, from 5.9 percent in 1982 to 6.1 percent in 1984. Both the individual and corporate income taxes contribute a smaller share of Federal receipts in 1984. The individual income tax share declines from 48.2 to 44.8 percent, and the corporate income tax declines from 8.0 to 7.9 percent of Federal receipts from 1982 to 1984.

Table 4

Composition of Federal Budget Receipts, Fiscal Years 1982-84
(Percent of total receipts)

Fiscal year	Individual income tax	Corporate income tax	Social insurance taxes & contributions	Excise taxes	Estate & gift taxes	Custom duties	Misc. receipts	Total
1982	48.2	8.0	32.6	5.3	1.3	1.4	2.6	100.0
1983*	47.7	5.9	35.2	6.2	1.0	1.5	2.4	100.0
1984*	44.8	7.9	36.8	6.1	0.9	1.4	2.1	100.0
Annual growth rate	-0.4	2.6	9.8	5.5	-14.1	1.7	-1.7	3.3

*Estimate

B. Economic Assumptions

The aggregate receipts and outlays projected in the Federal budget are quite sensitive to the underlying assumptions about the performance of the economy.

The Administration's 1984 budget forecasts assume that real GNP growth will be 3.1 percent in 1983 (fourth quarter over fourth quarter) and 4.0 percent in 1984 through 1988. This represents a substantial rebound from the 0.7 percent GNP growth recorded in 1981, and the 1.2 percent decline in GNP during 1982. Thus, the upswing in the business cycle originally forecast for 1982 is now anticipated in 1983. As shown in Table 5, the Administration forecasts a gradual improvement in employment in conjunction with the economic recovery.

Table 5

Economic Assumptions
(calendar years)

	Actual		Forecast					
	1981	1982[1]	1983	1984	1985	1986	1987	1988
GNP (1972 $) percent change	-1.2	3.1	4.0	4.0	4.0	4.0	4.0	4.0
CPI percent change[2]	9.4	4.4	5.0	4.4	4.7	4.5	4.5	4.4
Unemployment rate (percent)[3]	8.1	10.5	10.4	9.5	8.5	7.8	7.0	6.2
Interest rate 91-day Treasury bills (percent)[4]	14.1	10.7	8.0	7.9	7.4	6.8	6.5	6.1

[1] Preliminary actual data.
[2] CPI for urban wage earners and clerical workers. Two versions of the CPI are now published. The index shown here is that currently used, as required by law, in calculating automatic cost-of-living (COL) increases for indexed Federal programs. The figures in this table reflect the actual CPI for December 1982, released January 21, 1983, which was 0.7% lower than had been projected, consequently, the COL adjustments estimated in the budget are higher than the actual adjustments will be.
[3] Percent of total labor force, including armed forces stationed in the U.S.
[4] Average rate on new issues within period, on a bank discount basis. These projections assume, by convention, that interest rates decline with the rate of inflation. They do not represent a forecast of interest rates.
[5] Growth rates are measured as the 4th quarter of the current year over the 4th quarter of the previous year.

The unemployment rate is expected to decline slightly to 10.4 percent in the fourth quarter of 1983, and more rapidly to 9.5 percent in 1984, 8.5 percent in 1985, and 7.8 percent in 1986. The inflation rate is expected to rise slightly from 4.4 percent in 1982 to 5.0 percent in 1983. In the out-years, inflation levels off in the 4.4 to 4.7 percent range. At these lower inflation rates, the budget assumes that the 91-day Treasury bill rate will decline from an average of 10.7 percent in 1982 to 8.0 percent in 1983, and thereafter decrease steadily to 6.1 percent in 1988.

Small differences in the estimated rate of GNP growth have a large impact on projected deficits. The Administration estimates that if real GNP growth is 1.0 percent less than predicted, then the deficit will be 6 percent above forecast in 1984, 10 percent above forecast in 1985, rising to 25 percent above forecast in 1988. Conversely, as shown in Table 6, if real GNP growth is 1.0 percent more than predicted, then the deficit is estimated to be 5 percent below forecast in 1984, 10 percent below forecast in 1985, falling to 26 percent below forecast in 1988.

Table 6

Impact of Higher or Lower Growth on the Deficit
(Percent of current services budget deficit)

GNP Growth Rate	Fiscal Year					
	1983	1984	1985	1986	1987	1988
1% above forecast[1]	-1.5	-5.4	-10.0	-14.9	-19.8	-26.3
1% below forecast[1]	1.7	5.6	10.0	14.6	19.2	25.4

[1]Beginning January 1983.

C. Current Services Budget

One perspective on the fiscal year 1984 budget proposal is the level of outlays and receipts relative to the current services budget (CSB). The CSB measures the budget receipts and outlays which would occur if current spending and tax programs were continued without change. In 1984 the CSB deficit is projected at $232 billion, or $43 billion more than the proposed budget deficit. As shown in Table 7, $32 billion of the savings come from outlay reductions, of which $30 billion is the direct result of programmatic reductions, and $2 billion is attributable to reduced borrowing costs. The deficit is narrowed, relative to the continuation of current law, by an additional $11 billion as a result of the proposed increases in social security contributions. In the absence of the spending and revenue programs proposed in the fiscal year 1984 budget, the Administration estimates that the deficit would rise to $300 billion in 1988, $183 billion more than the proposed budget. Relative to the CSB, the Administration budget achieves markedly lower deficits in the out-years primarily as a result of large defense savings, the contingency tax plan, and increases in retirement contributions.

Table 7

The 1984 Fiscal Plan
(in billions of dollars)

	1984	1985	1986	1987	1988
Current services deficit	232	253	271	292	300
Proposed budget deficit	189	194	148	142	117
Proposed deficit reduction	43	59	123	150	183
Total outlay reduction	32	48	62	82	100
Programmatic reduction	30	42	49	60	67
Net interest savings	2	6	13	22	33
Total receipt increase	11	11	61	67	84
Other revenue changes	11	11	15	18	32
Contingency tax plan	--	--	46	49	51

III. SUMMARY OF ADMINISTRATION'S REVENUE PROPOSALS

A. Revenue Increases

1. Tax proposals relating to social security[1]

a. Expansion of social security coverage

Present Law

Under present law, (1) Federal civilian employees, (2) employees of State and local governments, and (3) employees of religious, charitable, educational, and certain other tax-exempt organizations are exempt from mandatory social security coverage. However, effective on January 1, 1983, Federal civilian employees became subject to the medicare tax (Hospital Insurance Trust Fund) of 1.3 percent.

Employees of a State or local government may be covered under social security to the extent provided by voluntary agreements entered into by the State with the Secretary of Health and Human Services. A State may terminate a coverage agreement by giving two years advance notice to terminate, if the coverage agreement has been in effect for at least five years at the time the notice is given.

A tax-exempt organization generally may waive the exemption from mandatory social security coverage for services performed by its employees.

Administration Proposal

Under the Administration proposal, mandatory social security coverage would be extended to all new Federal civilian employees and to employees of tax-exempt organizations effective January 1, 1984. State and local governments currently participating in the social security system would no longer be allowed to terminate a coverage agreement.

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[1] These social security tax proposals are the same as recommended in the report by the majority of the National Commission on Social Security Reform.

b. Acceleration of increases in OASDI payroll tax rate

Present Law

The Federal Insurance Contributions Act (FICA) imposes two taxes--old age, survivors and disability insurance (OASDI), and hospital insurance (HI)--on employees and employers. The current OASDI rate is 5.4 percent (a combined employee and employer rate of 10.8 percent). This rate is scheduled to increase to 5.7 percent (a combined rate of 11.4 percent) in 1985 and to 6.2 percent (a combined rate of 12.4 percent) in 1990.

Under present law, employees do not receive an income tax credit for OASDI taxes paid.

Administration Proposal

The Administration proposal would accelerate to 1984 the scheduled OASDI rate increase for 1985, and would increase the scheduled OASDI rate for 1988 and 1989. The rate increases would apply both to employee and employer OASDI taxes, but not to HI taxes.

Under the proposal, the OASDI rate would be increased from the current 5.4 percent (a combined rate of 10.8 percent) to 5.7 percent (a combined rate of 11.4 percent) with respect to wages received during calendar years 1984 through 1987. The OASDI rate would be increased further to 6.06 percent (a combined rate of 12.12 percent) with respect to wages received during calendar years 1988 and 1989 and 6.2 percent (a combined rate of 12.4 percent) with respect to wages received after December 31, 1989.

For 1984, employees would receive a refundable tax credit equal to the 1984 increase in OASDI tax rates (i.e., .3 percent of includible wages).

c. Self-employment OASDI tax rate increases

Present Law

The Self-Employment Contributions Act imposes two taxes (OASDI and HI) on self-employed individuals. The current OASDI rate for self-employed individuals is 8.05 percent. This rate is scheduled to increase to 8.55 percent in 1985.

Under present law, self-employed individuals do not receive an income tax deduction for self-employed OASDI taxes paid.

Administration Proposal

Under the Administration proposal, the OASDI rate for self-employed individuals would be equal to the combined employer-employee OASDI rate, beginning in 1984. Thus, the self-employed OASDI rate would be 11.4 percent for taxable years beginning after December 31, 1983, and before January 1, 1988. The tax rate would be 12.12 percent for taxable years beginning after December 31, 1987, and before January 1, 1990. Finally, for taxable years beginning after December 31, 1989, the rate would be 12.4 percent.

Under the proposal, self-employed individuals would be permitted to deduct for income tax purposes an amount equal to 50 percent of self-employment OASDI taxes paid. This deduction would be allowed in computing adjusted gross income.

d. Taxation of social security benefits

Present Law

Under a series of rulings in 1938 and 1941 by the Internal Revenue Service, social security benefits are excluded from gross income for purposes of the income tax.

Administration Proposal

Under the Administration proposal, one-half of an individual's social security benefit would be included in adjusted gross income if other adjusted gross income exceeds the base amount. The base amount would be $25,000 in the case of married couples filing a joint return and $20,000 in the case of a single taxpayer.

2. Exclusion for employer-provided health insurance premiums

Present Law

Under present law, employer contributions to accident or health plans to compensate employees for personal injuries or sickness (through insurance or otherwise) are excluded from an employee's gross income. Amounts paid to or on behalf of an employee under an employer's accident or health plan to reimburse the employee for expenses incurred for medical care (including medical care provided the employee's spouse or dependents) also are generally excluded from the employee's income.

Under present law, employer contributions to accident or health plans for employees, and payments made to employees under such plans, generally are not subject to social security taxes.

Administration Proposal

Under the Administration proposal, for taxable years beginning after December 31, 1983, employer contributions to accident or health plans for an employee would be included in the employee's income to the extent they exceed (1) $175 per month ($2,100 per year) if the plan covers the employee and his family, or (2) $70 per month ($840 per year) if the plan covers only the employee. The $175 and $70 amounts would be indexed to increase with inflation.

Amounts included in the employee's income under the proposal would also be subject to social security taxes.

There would be a transition rule to exempt premiums paid under collective bargaining agreements signed before January 31, 1983.

3. Contingent taxes: oil excise tax and income tax surcharge

Present Law

Present law imposes several excise taxes on petroleum and petroleum products, the revenues from which are dedicated to various trust funds. Gasoline, diesel fuel and other motor fuels are taxed at 4 cents per gallon (9 cents, beginning April 1, 1983), and revenues are transferred principally to the Highway Trust Fund. Gasoline and nongasoline fuels used in noncommercial aviation are taxed at 12 and 14 cents per gallon, respectively, and revenues are transferred to the Airport and Airway Trust Fund. Crude oil is taxed at 0.79 cents per barrel, and revenues are transferred to the Hazardous Substance Response Trust Fund. Diesel fuel and other liquid fuels used for commercial cargo vessels on inland or intracoastal waterways are taxed at 6 cents per gallon (8 cents, beginning October 1, 1983, and 10 cents, beginning October 1, 1985). Revenues from this tax are transferred to the Inland Waterways Trust Fund.

Under the Trade Expansion Act of 1962, the President can impose oil import fees or other import restrictions if he finds that imports threaten the nation's security. Congress may roll back the fees by passing a joint resolution of disapproval. This resolution can be vetoed by the President, in which case the fees would continue unless the veto is overridden by a two-thirds vote of both Houses of Congress. (The presidential import fee authority was used by Presidents Nixon, Ford and Carter.) Nominal oil import duties are now in effect, none of which was imposed under this authority.

Present law makes no provision for contingent income tax surcharges.

Administration Proposal

The Administration proposes two new contingent taxes. The first is an excise tax on oil, both domestically produced and imported, that would be designed to raise revenues of about $5 per barrel. The second is a surcharge on individuals and corporations approximately equivalent to 1 percent of taxable income. This tax could be structured as a 1-percent tax on taxable income or as a 5-percent surtax on taxes paid.

Both contingent taxes would become effective only if three conditions are met: (1) Congress adopts the Administration's spending reductions and structural changes of federal entitlement programs, (2) the Administration forecasts on July 1, 1985, that the fiscal year 1986 unified budget deficit will exceed 2-1/2 percent of the gross national product, and (3) the economy is growing on July 1, 1985.

The Administration proposes that these contingency taxes be enacted in 1983. They would be effective on October 1, 1985, and would last for up to 3 years.

B. Revenue Reductions

1. Education savings accounts

Present Law

Under present law, there is no general provision which permits deductions for amounts contributed to a trust to pay education expenses of the taxpayer or a child of the taxpayer or for income from assets in such a trust. However, certain types of "job-related" education expenses may be deducted as ordinary and necessary business expenses.

Administration Proposal

The Administration proposal would create a permanent tax exclusion for all interest and dividends earned on amounts deposited in qualified education savings accounts, after December 31, 1983, provided the deposits are used for eligible education expenses. If amounts are withdrawn from the account and not applied to eligible education expenses, the tax otherwise due on the earnings will be recaptured and a penalty tax generally will be imposed.

In general, eligible education expenses are tuition and room and board incurred on behalf of a full-time undergraduate student and paid directly to a university or college. However, amounts paid to schools that follow a racially discriminatory policy will not be treated as eligible expenses. Certain reporting obligations would be imposed on the financial institutions maintaining the accounts and the colleges or universities receiving withdrawals from such accounts.

Deposits to these accounts are subject to a number of limitations. First, under the proposal, the maximum annual contribution to a qualified education savings account would be $1,000 per child. However, the $1,000 limit would be reduced by 5 percent of the amount by which the taxpayer's adjusted gross income exceeds $40,000. Thus, no contribution could be made by a taxpayer whose adjusted gross income exceeds $60,000. Second, no contribution may be made on behalf of a child over the age of 18, and in no case may an account be maintained for a child over the age of 25.

2. Tuition tax credits

Present Law

Present law provides no tax credit or deduction for personal educational expenses. However, certain types of "job-related" education expenses may be deducted as ordinary and necessary business expenses.

Administration Proposal

The Administration proposal would provide a nonrefundable tax credit for 50 percent of certain tuition expenses paid to private elementary and secondary schools for qualified dependents of the taxpayer. The maximum credit would be $100 in 1983, $200 in 1984, and $300 in 1985 and subsequent years. Additionally, the maximum credit would be phased down for taxpayers with adjusted gross incomes greater than $40,000, with no credit being allowed to taxpayers with adjusted gross incomes in excess of $60,000.

For tuition expenses to be creditable, a school could not follow a racially discriminatory policy. An eligible school would be required to include a statement of its nondiscriminatory policy in any published by-laws, admissions materials, and advertising and to file annually with the Treasury Department a statement that it has not followed a racially discriminatory policy. Generally, a copy of this statement would have to be furnished to each individual who pays tuition to the school and would have to be attached to any return on which credits were claimed. In addition, the proposal would disallow credits for payments to any school found to be following a racially discriminatory policy in a declaratory judgment action brought by the Attorney General.

This proposal would be effective for expenses incurred after July 31, 1983.

Prior Congressional Action

During the 97th Congress, the Senate Finance Committee reported a similar proposal as an amendment in the nature of a substitute to H.R. 1635 (S. Rep. 97-597, Sept. 23, 1982), but it was not considered by the Senate.

3. Caribbean Basin Initiative

Present Law

Rum excise tax payments to Puerto Rico and the Virgin Islands

The United States imposes excise taxes of $10.50 per proof gallon on all distilled spirits, including rum, manufactured in or brought into the United States. The excise taxes paid on rum made in Puerto Rico and the U.S. Virgin Islands and brought into the United States are transferred to the Treasury of the island where the rum was made.

Caribbean conventions

The Internal Revenue Code generally disallows deductions for business expenses incurred while attending a convention held outside the North American area (the United States, the U.S. possessions, the Trust Territory of the Pacific Islands, Canada and Mexico). Deductions for attending conventions held outside the North American area are allowable only if the taxpayer can show that it was as reasonable to hold the convention outside the North American area as within it. Business expense deductions of up to $2,000 per individual are allowable for conventions held on U.S. flag cruise ships that call on ports only in the United States and the U.S. possessions. The income tax treaty with Jamaica allows business expense deductions for attending conventions held in Jamaica.

Administration Proposal

The Administration's Caribbean Basin Initiative, as included in the Fiscal Year 1984 Budget Document, includes both tax and nontax proposals. This Summary describes only the tax proposals.

Rum excise tax payments to Puerto Rico and the Virgin Islands

The Administration proposal would require that all excise taxes collected on foreign rum brought into the United States (whether or not from Caribbean countries) would be transferred to the Treasuries of Puerto Rico and the Virgin Islands. The Secretary of the Treasury would prescribe a formula for allocating these taxes between Puerto Rico and the Virgin Islands. This provision would apply to rum imported into the United States on or after April 1, 1983.

Caribbean conventions

The Administration proposal would allow business expense deductions for attending conventions held in certain Caribbean

countries. Such treatment would apply only for a Caribbean country that met certain criteria.

First, the country would have to be a "beneficiary country" as defined in the trade portion of the Caribbean Basin Initiative proposal. That is, it would have to be among the 28 Caribbean Basin countries listed in section 102(b) of H.R. 7397 (as it passed the House of Representatives in 1982) and it would have to be designated by the President as a beneficiary country. In addition, a deduction would be provided for conventions held in Bermuda provided that Bermuda met the other criteria.

Second, the country would have to enter into an executive agreement with the United States to provide for the exchange of tax information. The agreement would be negotiated by the Secretary of the Treasury. It would provide, on a reciprocal basis, for information relating to U.S. tax matters to be made available to U.S. tax officials. The agreement would have to apply to both civil and criminal tax matters. It would have to override any local rules requiring secrecy about the ownership of bank accounts or bearer shares. The agreement would impose on the officials of each country a duty not to disclose this information other than to those involved in its tax administration.

Third, no deduction would be available for attending a convention in a country found by the Secretary of the Treasury to discriminate in its tax laws against conventions held in the United States.

This provision would apply to conventions beginning after December 31, 1982, but only if an exchange of information agreement were in effect on the day the convention began.

Prior Congressional Action

The proposal described above (with one difference in effective date), together with nontax portions of the Caribbean Basin Initiative, passed the House of Representatives on December 17, 1982, as H.R. 7397. The Senate Finance Committee ordered that bill reported on December 20, 1982, with modifications to certain nontax provisions of the bill but without modifications to the tax provisions, by a vote of 11 to 5. The Senate did not consider the reported bill before adjournment sine die of the 97th Congress.

The tax portion of the Administration's current proposal differs from the tax portion of H.R. 7397 in one way: under H.R. 7397, excise taxes collected on all rum imported into the United States on or after January 1, 1983 would have been transferred to Puerto Rico and the Virgin Islands. The corresponding date in the Administration's proposal is April 1, 1983.

4. Enterprise zone tax incentives

Present Law

Under present law, the only tax incentive for the redevelopment of economically distressed areas is a relaxation of limitations on tax-exempt financing for facilities receiving assistance under the Urban Development Action Grant (UDAG) program.

Administration Proposal

The Administration proposes that beginning in 1983 up to 25 small areas per year (not to exceed 75 in total) be designated "enterprise zones." Effective January 1, 1984, the following tax incentives would be available for economic redevelopment in the zones: an exemption from tax of capital gains on certain qualified property, a tax credit for employees equal to 5 percent of the first $10,500 of wages earned, a tax credit for employers equal to 10 percent of any increases in their payrolls (up to $1,750 per employee) a separate tax credit for employers of certain disadvantaged individuals equal to 50 percent of the wages of such persons for the first three years of employment (the percentage declines by 10 points in the fourth year and each year thereafter), an increase of 50 percent in the regular investment tax credit for investment in equipment, a 10-percent investment tax credit for new construction and reconstruction of buildings, and continued availability of tax-exempt bond financing beyond the 1986 sunset date for small issue bonds. These incentives generally would remain fully in effect for 20 years and would be phased out over the succeeding four years. (An enterprise zone could be designated for a period of less than 20 years.)

Prior Congressional Action

A similar proposal was reported by the Senate Finance Committee in the 97th Congress (H.R. 7094 as reported; Sen. Rep. No. 97-662, Oct. 18, 1982), but was not considered by the Senate.

5. Jobs tax credit for the long-term unemployed

Present Law

Under present law, the targeted jobs credit is available to employers for a portion of wages paid to members of nine target groups of individuals. All groups are defined with reference to low family income, receipt of means-tested transfer payments, or disability.

Administration Proposal

The Administration proposes a six-month extension and modification of the Federal Supplemental Compensation program with an option for recipients to receive assistance in securing work through a system of tax credits to employers. To be qualified, individuals must have exhausted their regular, and, where available, extended Unemployment Insurance benefits.

Effective April 1, 1983, individuals who meet the eligibility requirements for the additional unemployment payments may elect to receive vouchers equivalent in value to the unemployment payments. These vouchers will entitle an employer to receive the credit for hiring qualified individuals for full-time employment within six months of their eligibility. Although payment of the additional benefits will end on September 30, 1983, individuals will be able to become eligible for vouchers until March 31, 1984. Employers will be able to receive a tax credit for any qualified individuals hired before April 1, 1984.

III. ADMINISTRATION'S ESTIMATES OF BUDGET EFFECTS OF REVENUE PROPOSALS 1/

(Fiscal Years, 1983-1986; in Billions of Dollars)

Item	1983	1984	1985	1986
Revenue increases				
1. Social security related tax proposals	--	8.2	5.8	8.9
2. Exclusion for employer-provided health insurance premiums	--	2.3	4.4	6.0
3. Contingency tax plan:	--	--	--	46.0
Oil tax				
Income tax surcharge	—	—	—	—
Subtotal, revenue increase provisions	--	10.5	10.2	60.9
Revenue reductions				
1. Education savings accounts	--	2/	-.1	-.2
2. Tuition tax credit	--	-.2	-.5	-.8
3. Caribbean Basin Initiative	2/	2/	2/	2/
4. Enterprise zone tax incentives		-.1	-.4	-.8
5. Tax credit for hiring long-term unemployed	2/	-.2	-.2	-.1
Subtotal, revenue reduction provisions	2/	-.6	-1.2	-2.0
Total, tax provisions	2/	10.0	9.0	59.2
Civil service retirement contributions	--	1.2	2.3	2.1
Total, Revenue Provisions, Including Civil Service Retirement Provisions	2/	11.2	11.3	61.3

Note: Details may not add to totals due to rounding.

1/ These estimates are based on the direct effect only of legislative changes at a given level of economic activity. Induced effects are taken into account for forecasting incomes, however, and in this way affect the receipts estimates by major source and in total.

2/ Revenue reduction of $50 million or less.

Source: Budget of the United States Government, Fiscal Year 1984.

The CHAIRMAN. Mr. Secretary, since I know you must leave about noon, and I know a number of our members are probably caught up in the traffic following the prayer breakfast, it might be well if we could go ahead and start on your statement. And then as other members come, they could make any opening statements they wish and ask questions. And we can take their opening statements out of their time allotment—I know Senator Long is on his way, and I am certain other Senators will be here—if that is satisfactory.

STATEMENT OF HON. DONALD T. REGAN, SECRETARY OF THE TREASURY

Secretary REGAN. Mr. Chairman, it is a pleasure to meet with you today to discuss the administration's 1984 budget proposals. The transition to a noninflationary environment has been somewhat more difficult than anticipated. We have seen 2 years of serious economic recession as a result of the inflation/tax spiral.

However, the worst is now over. There has been clear progress on inflation, and consumer price growth has dropped dramatically from 12.4 percent in 1980 to 3.9 percent in 1982. Prime interest rates are down from peak levels of 21.5 percent to 11 percent currently.

The task now is to encourage the renewal of economic growth to reduce unemployment and provide productive job opportunities in the private sector. In so doing we must not repeat the errors of the past and return to an inflationary economy.

Inflation has led to a roughly parallel rise in key interest rates. As shown in chart I on interest rates and inflation, the 3-month Treasury bill rate followed the rate of inflation very closely over most of the period from the early 1960's to present. Thus, inflation appears to have been a major factor in the increase in the bill rate during that time.

Rising rates of inflation after the mid-1960's did not lead to more rapid economic growth for any sustained period of time. Quite the contrary. Inflation and its inevitable consequence of higher interest rates finally choked off real growth altogether.

Over the past 2 years we have seen evidence that the administration's program is working. The fundamental elements of recovery are now largely in place. Inflation has been brought under control. Interest rates are coming down, as shown in chart II. You can see the prime rate coming down here, the rate for corporate bonds are down, and again the 3-month Treasury bill, and real wage growth is being restored.

There are now clear signals that the economy is turning around and that the recession will soon be behind us. To summarize these signals:

First, the index of leading indicators has risen for 8 out of the last 9 months;

Housing is in the midst of a rapid recovery;

Business trimmed inventories sharply in the final quarter of last year. Historically, a cleanout of inventories typically has been followed by a shift back to higher rates of production;

Retail sales have begun to firm;

And total industrial production stabilized in December and appears poised to turn upward.

Now, Mr. Chairman, we had all hoped for a vigorous recovery, not unlike those which have occurred in the past. The typical postwar recovery path is shown here in this chart, and that is the blue line starting over here, and the quarters just prior to the trough.

And then you see what happens in eight quarters following the trough of the recession. We have excluded from this chart the Korean war buildup and the second which got underway late in 1980 but was short-lived.

The five recoveries contained in the average line in the chart were remarkably similar. Gains over the first eight quarters from real GNP trough were within an extremely narrow range of 5 to 6 percent at an annual rate.

The contributions of GNP components to real growth during the typical recovery are shown in this chart. As it indicates, much of the initial thrust for expansion comes, first, from a resurgence in homebuilding activity, and that is currently underway. That is the green portion on the chart.

A swing in inventory investment from decumulation in the later stages of the recession to accumulation. That is the yellow portion on this chart.

A major contribution from consumer spending with purchases of consumer durables registering particularly large increases. That is this orange on the chart.

By contrast, Mr. Chairman, Federal spending normally declines as a share of GNP during recovery and is not necessary for promoting expansion. That is this negative blue here at the bottom of the chart.

Now, as you can see, these three things I have mentioned—the residential construction, inventory investment, consumer spending—they have all taken a turn upward at this stage of the recovery, so a vigorous recovery of that type would be most welcome. It would certainly help ease the Nation's budgetary problems.

However, we recognize that the serious problems still confronting us may well hold growth during the next year or two below the typical recovery pattern. The administration is forecasting fairly modest real growth at a 3.1-percent rate during the first four quarters of 1983 rather than the typical recovery growth rate of about twice that amount, though certainly we would welcome a stronger recovery. Growth is expected to pick up modestly to the 4-percent range in 1984 and the years beyond.

Policies for the recovery: In setting policy for the remainder of the 1980's, we must recognize what we must not do. We no longer have the freedom of action to revert back to the overly stimulative monetary and fiscal policies pursued at times in the past, for these would surely lead to a resurgence of inflationary pressures and a new round of rising interest rates.

Further, we must not reverse the fundamental tax restructuring put in place in 1981, for this was designed to provide the noninflationary incentives without which the private sector would continue to wither. The tax reforms that were put in place were designed primarily to restore an adequate rate of return for investment in

plant and equipment and to put a halt to the steady ratching upward of marginal tax rates on labor and savings income.

The investment incentives were necessary to bring long depressed rates of business capital investment and productivity growth back up to acceptable standards. For individuals the tax cuts were needed to protect incentives and purchasing power and to keep American labor competitive in world markets. For the average taxpayer they will only result in an actual dollar tax cut in 1983 after allowance for the effects of bracket creep and higher social security taxes, and that 1983 cut and tax indexing will be needed to offset bracket creep and increases in social security taxes scheduled to take effect in the future.

These measures will greatly improve the competitive standing of American capital and labor in the world as economic recovery proceeds. Those who would repeal indexing and the 10-percent tax cut due on July 1, 1983, inflict a painful injustice on the working men and women of this country.

In 1985 repeal of both of these would mean a 24.3-percent tax increase for those earning less than $10,000 and only a 3.1-percent tax increase for those earning more than $200,000. Seventy-four percent of the benefits of the third-year tax cut and indexing go to taxpayers with incomes below $50,000. In total, repeal would result in a massive $273.2 billion tax increase between fiscal year 1983 and 1988.

As the President has said, it makes no sense to raise taxes just as we are coming out of a recession. Nor does it make any sense to place the tax burden on the backs of low- and middle-income families.

We need more economic growth in this country that will put people back to work and increase our tax base. Repeal is a bad idea at the wrong time and the wrong place.

Another caution is in order. At a time in which we are facing high deficits, it would be grossly unfair to repeal the tax provision requiring withholding on interest and dividends. Under withholding there is no tax increase on honest taxpayers. Almost all of the revenue increase comes from taxpayers who are not paying the tax that they now owe.

Repealing withholding would result in a revenue loss of over $16 billion over the next 5 years. We can hardly ask honest taxpayers to pick up this additional burden.

Repealing withholding at this time would also send a message that the Government does not take seriously the major effort initiated last year to insure better compliance with the tax laws in general.

Spending reduction will contribute to the recovery, and the recovery will contribute to deficit reduction. The deficit will fall as the economy advances, particularly if the recovery is a vigorous one. A strong recovery with 1⅓ percent more real growth per year than in our forecast would bring the budget to near balance by 1988, provided we also curb the growth of Federal outlays.

However, if we fail to bring spending under control, and if recovery is slow, we will face a deficit problem that is larger and longer lasting than we can afford. In such a case, the deficit could run in

the range of 6 to 7 percent of gross national product each year through 1988.

Our tax reforms were designed to raise the private savings rate share. But still, we would face the possibility of draining off a large part of the pool of savings, leaving less available for new capital formation. Interest rates could remain high, and the recovery could stall. This administration is determined that deficits of such magnitudes will not come to pass.

The deficit reduction program that we propose contains four basic elements: First, is a freeze on 1984 outlays to the extent possible. Total outlays will be frozen in real terms in 1984. The 6-month freeze on COLA's, as recommended by the Social Security Commission, is to be extended to other indexed programs. There will be a 1-year freeze on pay and retirement of Federal workers, both civilian and military.

The second element of our budgetary program contains measures to control the so-called uncontrollables. We plan a careful review of all such programs, taking special care to protect those truly in need.

The third element is a cutback of $55 billion in defense outlays from the original plans.

Fourth is a set of proposals involving the revenue side of the budget. We are projecting receipts for the current year—that is, fiscal 1983—of $597.5 billion. In 1984, as the recovery is well underway, receipts are expected to rise to $659.7 billion, an increase over 1983 of $62.2 billion, representing an annual growth of 10.4 percent.

This will occur as profit margins recover and other income continues to grow. For the other years in our forecast period 1985–88, we project an average annual growth rate of receipts of about 10 percent without contingency taxes—and 11 percent including them—with receipts reaching the $1 trillion mark for the first time in fiscal 1988. All of these projections assume the legislative proposals included in the President's fiscal year 1984 budget are enacted.

There has been a gradual upward trend in unified budget receipts as a percentage of gross national product, which is shown in the top line of this chart V. You can see the gradual rise from 1954 on up, and this is out to 1988. As shown in the bottom line of the chart, a major shift in the composition of receipts has been the rising share of social insurance and other payroll taxes to fund social security and other retirement benefits. The total of all the other receipts, of course, has been falling as a percentage of the total.

There is no proposed omnibus tax bill in the President's budget message. There are, however, eight major proposals concerning taxes:

First, we are endorsing the bipartisan social security plan with sufficient tax changes to insure the future solvency of the social security trust funds and to restore the confidence of present and future retirees in this vital program.

We are also reintroducing with some modifications three proposals considered by this committee last year: the Caribbean Basin Initiative; the enterprise zone legislation to stimulate the economic

development of distressed areas; and tuition tax credits to ease the financial burden of families who send their children to private schools.

Next, the President has proposed three new tax initiatives: a jobs tax credit for the long-term unemployed; a cap on the amount of employer-paid health insurance premiums that may be excluded from employees' taxable incomes; and finally, a limited exclusion from tax for earnings on savings set aside for higher education expenses.

And last, the President has proposed a contingency tax plan designed to raise revenues of about 1 percent of gross national product in the event that after Congress has adopted the spending reduction proposals there is insufficient economic growth to reduce the deficit below 2.5 percent of gross national product for fiscal year 1986.

Even if that condition is met, the contingency tax plan would not go into effect on October 1, 1985, unless the economy is growing on July 1, 1985. The contingency tax plan is really an insurance program. It is important to have a plan in place so that everyone will know that we will not tolerate a string of deficits that continue to exceed 2.5 percent of GNP.

Chart VI shows the effects on the deficit that the contingency tax would have if it were implemented. The deficit under the high growth path reflects the assumption that real gross national product would increase 1⅓ percentage points faster than is in the official forecast path, starting in 1983.

You can see that here, Mr. Chairman. This is the growth path that we say we are on according to our projections. With the contingency tax as a percent of GNP, the deficit drops into the 2.5 percent range.

The high growth path, which is about the equivalent of all post-World War II recoveries, takes it up into here and the rate then drops dramatically and crosses the 2.5 percent line by 1986 and practically to zero in 1988.

The contingency tax plan would contain two elements, each raising about half of the revenues that will be required. One element would be a temporary surcharge of 5 percent on individuals and corporations. The other element would be a temporary excise tax on domestically produced and imported oil, designed to raise revenues of about $5 a barrel.

The contingency tax alternative shown in the budget raises $146 billion over the 36-month period beginning October 1, 1985. The specific contingency tax plan we will be sending to Congress for adoption this year will be designed to raise revenues of about $130–$150 billion over a temporary period of up to 36 months.

In addition to these eight specific tax proposals, the President has also directed the Treasury Department to undertake a careful study of the current income tax structure. We will be searching for ways to simplify the tax system to make it fair and to remove tax obstacles to economic growth and expanding employment.

If these budget savings proposals are enacted, we will reduce the projected deficits by a total of $580 billion over the next 5 years, or $2,400 for every woman, man, and child in the United States. The deficit as a share of gross national product will be down to below

2.5 percent in 1988 from the 6.5 percent we expect this year. Total real outlays will grow by only 1.9 percent per year over the next 5 years compared with the bloated 3.9 percent between 1977 and 1981.

We are confident that the deficit reduction program contained in this realistic budget is the right program for the economy at this critical juncture. The most important signals we can send the economy are spending restraint, deficit restraint, and a commitment to noninflationary economic growth throughout the decade.

This is the program we have devised. Together with the Congress and this committee, Mr. Chairman, we can make it work. Thank you very much.

[The statement of Secretary Regan follows:]

FOR RELEASE UPON DELIVERY
EXPECTED AT 9:30 A.M.
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TESTIMONY OF THE HONORABLE DONALD T. REGAN
SECRETARY OF THE TREASURY
BEFORE THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today and to discuss the Administration's 1984 budget proposals. The development of a sound fiscal policy was one of the central objectives of the Reagan Administration when it came into office two years ago. For too long a time Americans had watched the share of GNP accounted for by Federal spending and taxes move upward. As the government siphoned off resources from the private sector and the money supply expanded, economic activity stagnated and inflation soared.

In February 1980 the Administration put before Congress a four point plan to revitalize the economy. Our program included spending restraint, tax reductions, regulatory reform, and support of the Federal Reserve's efforts to attain gradual, steady reduction in the rate of monetary growth.

The transition to a noninflationary environment has been somewhat more difficult than anticipated. We have seen two years of serious economic recession as a result of the inflation/tax spiral.

However, the worst is now over. There has been clear progress on inflation, and consumer price growth has dropped dramatically from 12.4 percent in 1980 to 3.9 percent in 1982. Interest rates are down from peak levels of 21-1/2 percent on the prime in December 1980 to 11 percent currently, and the stock market last year made new highs. Indicators such as housing, inventories, and real income show the economy is poised for recovery. Alongside these favorable developments, there remains distressingly high unemployment.

The task now is to encourage the renewal of economic growth to reduce unemployment and provide productive job opportunities in the private sector. In so doing we must not repeat the errors of the past and return to an inflationary economy.

The current domestic situation is complicated by the existence of large Federal budget deficits and the threat of even larger ones in years to come. These budget deficits will have to be reduced, since their persistence would inevitably lead to very adverse consequences for the U.S. economy and its financial markets.

Many of the economic difficulties we face at home are also faced by countries abroad. The entire international economy is experiencing a severe slowdown, complicated by the special debt-servicing problems of a number of countries. My prepared statement today deals primarily with the U.S. domestic economy, but it is obvious that the domestic and international situations are closely linked. The clear need in both cases is to encourage expansion rather than undergo further contraction.

It is important to recognize that current difficulties are the culmination of a long period of deteriorating economic performance in this country. The U.S. economy was in deep trouble long before the current recession began. It follows that our policies must aim at lasting long-run solutions. There are no quick cures.

Inflation has led to a roughly parallel rise in key interest rates. As shown in Chart I on interest rates and inflation, the 3-month Treasury bill rate followed the rate of inflation very closely over most of the period from the early 1960's to present. Thus, inflation appears to have been a major factor in the increase in the bill rate during that time.

Rising rates of inflation after the mid-1960's did not lead to more rapid economic growth for any sustained period of time. Quite the contrary. Inflation and its inevitable consequence of higher interest rates finally choked off real growth altogether.

Approach of the Reagan Administration

The Administration's primary economic goal upon coming to office was a fundamental restructuring of the economy, including:

- bringing inflation under control;
- shifting the composition of activity away from government spending toward more productive endeavors in the private sector;
- providing an environment which would reward innovation, work effort, saving and investment, and in which free-market forces could operate effectively.

Over the past two years we have seen evidence that the Administration's program is working. The fundamental elements of recovery are now largely in place. Inflation has been brought under control. Interest rates are coming down, as shown in Chart II. Real wage growth is being restored. In addition, there have been other improvements -- notably in productivity growth and saving behavior -- which mark a shift away from the problems that contributed to sluggish economic performance in recent years.

Within this framework of very significant achievements, there remains the fact that the economy has been in recession and unemployment is high. The unemployment rate of 10.8 percent in December is, of course, a matter of great concern. The President has indicated in his State of the Union Message that he will be submitting special legislation to help deal with the problem.

The Current State of the Economy

The economy now stands poised for recovery. In fact, the recovery may well already be underway at this moment. It has been much longer in coming than we, or for that matter nearly all forecasters, had expected.

The delay occurred primarily because of the persistence of high interest rates and because of developments in the international sphere. On the international front, the economies of our leading trading partners continued to weaken. Weakness among all the industrialized nations was self-reinforcing. Furthermore, the financial difficulties of some of the newly industrializing nations had adverse impacts on economic activity here. These forces, combined with a general hesitancy on the part of the consumer, led to another round of inventory cutting in the second half of 1982 and delayed the expected turnaround of the economy.

Signals of an Economic Upturn

There are now clear signals that the economy is turning around and that the recession will soon be behind us. To summarize these signals:

- The index of leading indicators has risen for eight out of the last nine months.
- Housing is in the midst of a rapid recovery.
- Business trimmed inventories sharply in the final quarter of last year. Historically, a cleanout of inventories typically has been followed by a shift back to higher rates of production.
- Retail sales have begun to firm.
- Total industrial production stabilized in December and appears poised to turn upward.

The Typical Recovery

We would all hope for a vigorous recovery, not unlike those which occurred in the past. The typical postwar recovery path is shown in Chart III. Excluded from it are two atypical recoveries -- the first of which included the Korean War buildup and the second which got underway late in 1980 but was short-lived. The five recoveries contained in the average line in the chart were remarkably similar. Gains over the first eight quarters from the real GNP trough were within an extremely narrow range of 5 to 6 percent at an annual rate.

The contributions of GNP components to real growth during the typical recovery are shown in Chart IV. As it indicates, much of the initial thrust for expansion comes from:

- a resurgence in homebuilding activity, such as currently is underway;
- a swing in inventory investment from decumulation in the later stages of recession to accumulation; and
- a major contribution from consumer spending, with purchases of consumer durables registering particularly large increases.

By contrast, Federal spending normally declines as a share of GNP during recovery, and is not necessary for promoting expansion.

The Outlook for the Economy

A vigorous recovery of the type outlined would be most welcome. It would certainly help ease the Nation's budgetary problems. However, we recognize that the serious problems still confronting us may well hold growth during the next year or two below the typical recovery pattern.

- Our overall trade balance is likely to register further marked deterioration in the coming year.
- Real interest rates may persist at high levels, though remaining below those prevailing a year ago.
- The economy is in the process of undergoing marked structural change. Some of our industries may not quickly regain the vitality they experienced in the 1950's and 1960's. The shift of resources to emerging industries will take time.
- Most fundamentally, we are not yet fully out of the inflationary woods, and we cannot afford to direct monetary and fiscal policy toward excessively rapid economic expansion.

For these reasons, the Administration is forecasting fairly modest real growth at a 3.1 percent rate during the four quarters of 1983, rather than the typical recovery growth rate of about twice that much, though certainly we would welcome a stronger recovery. Growth is expected to pick up modestly to the 4 percent range in 1984 and the years beyond.

Policies for the Recovery

In setting policy for the remainder of the 1980's, we must recognize what we must not do. We no longer have the freedom of action to revert back to the overly stimulative monetary and fiscal policies pursued at times in the past, for these would surely lead to a resurgence of inflationary pressures and a new round of rising interest rates. Further, we must not reverse the fundamental tax restructuring put in place in 1981, for this was designed to provide the noninflationary incentives without which the private sector would continue to wither.

Policies for a Changing Economic Structure

For years private sector initiative and dynamic market forces have been stifled by unnecessary Federal regulation. It is important that we carry through with policies of reducing the regulatory burden on private industry. Noteworthy successes have been achieved in this area, particularly in the deregulation of the financial system. For the first time in the postwar period, small investors can count on being able to obtain market rates of return on their savings from banks and thrift institutions.

Further, we recognize that our economy and those of the other industrialized nations are undergoing a period of restructuring. This is an era of rapid technological change, and comparative advantage in the production of many goods and services is shifting from the already developed to the newly developing nations. Those nations which expend all their energies shoring up declining industries and resisting change will find themselves with industrial bases that are obsolete and with declining relative standards of living. Their more foresighted and innovative neighbors will be moving forward and capturing newly opening markets.

Government can ease the painful process of structural change within the economy. The President has announced a program that relies heavily on the market mechanism to deal with structural unemployment that stems from problems in both labor and product markets. This program will emphasize training, retraining and relocation, and job-search assistance for workers facing the lack or loss of jobs even after an economic recovery. Other proposals will be designed to reduce the barriers to youth employment.

Finally, in setting the proper course of policy for the 1980's, we must work closely with the other industrialized and newly industrializing nations of the world. Negotiations are nearing completion on measures to assure that the International Monetary Fund has adequate resources to help countries experiencing difficulties implement sound policies of economic adjustment. The negotiations are focusing in on an increase in IMF quotas to a new level in the range of $93-100 billion, representing an increase of 40-50 percent, and an expansion of the existing General Arrangement to Borrow (GAB) to a level of about $19 billion (from $7 billion). The participation of the United States in an increase in IMF resources is an essential complement to domestic measures to achieve sustainable economic growth and represents a valuable investment in defense of the economic interests of the American farmer, laborer, businessman, and consumer. The U.S. share of the increase in quotas and the GAB will be about $8 billion but will have no effect on net budget outlays or the budget deficit since simultaneous with any transfers to the IMF, the U.S. receives an offsetting increase in its international monetary reserve assets.

Legislation providing for the U.S. share of the increase in IMF resources will be submitted in the near future and I urge prompt approval by the Congress.

Monetary Policy

In addition to policies aimed at facilitating structural changes within the economy, we must maintain steady monetary and fiscal policies directed at reinvigorating economic activity. Steady, predictable money supply growth at a noninflationary pace has been, and continues to be, one of the major goals of the Administration's economic program. The Federal Reserve's efforts to achieve that goal have been complicated by a number of factors, such as far-reaching institutional changes in the banking and thrift industries. Nevertheless, the Fed has generally been successful, albeit in a somewhat erratic fashion.

Monetary policy faced a difficult and uncertain situation during much of the last year. Rapid institutional change in the form of new money market instruments blurred the boundaries between the various aggregates and made the achievement of any target rates of growth unusually difficult. There is also some indication that the recession may have led to an increased demand for liquidity and precautionary balances. In 1982, growth in monetary velocity -- the rate at which money is used -- turned negative for the first time in nearly three decades. Under the unusual economic and institutional circumstances of 1982, some temporary offset in the form of above-target rates of monetary growth was probably desirable.

The Federal Reserve's efforts to slow money growth have been accompanied by some volatile short-run swings. Growth in M1 was actually negative on a 13-week basis by mid-summer of last year, and then soared to the double-digit range by the end of the year. This recent acceleration has caused some observers to conclude that the fight against inflationary money growth has been abandoned. That is not true. Both the Administration and the Federal Reserve remain committed to the long-run goal of providing money growth at a noninflationary pace consistent with a steady and sustainable expansion of economic activity.

Fiscal Policy

The objectives of our fiscal policy upon coming to office two years ago were two-fold. First, we believed and still believe it was imperative to correct the disincentives to economic performance that had been built into the tax structure over the years. These disincentives arose in large measure, not by design, but through the interaction of a high rate of inflation with a progressive tax system and historical cost accounting of depreciable assets. Second, it was equally

imperative to reverse the seemingly inexorable growth of Federal spending, thereby freeing resources for use in the private sector. In moving to achieve these goals, we faced one major constraint, namely that our defense establishment had been allowed to deteriorate badly, so that our national survival mandated a stepped-up rate of defense spending.

The tax reforms that were put in place were designed primarily to restore an adequate rate of return for investment in plant and equipment and to put a halt to the steady ratcheting upward of marginal tax rates on labor and savings income. The investment incentives were necessary to bring long-depressed rates of business capital investment and productivity growth back up to acceptable standards. For individuals, the tax cuts were needed to protect incentives and purchasing power, and to keep American labor competitive in world markets. For the average taxpayer, they will only result in an actual dollar tax cut in 1983, after allowance for the effects of bracket creep and higher social security taxes. And that 1983 cut and tax indexing will be needed to offset bracket creep and increases in social security taxes scheduled to take effect in the future. These measures will greatly improve the competitive standing of American capital and labor in the world as economic recovery proceeds.

Those who would repeal indexing and the 10 percent tax cut due on July 1, 1983 inflict a painful injustice on the working men and women of this country. In 1985, repeal of both of these would mean a 24.3 percent tax increase for those earning less than $10,000 and only a 3.1 percent tax increase for those earning more than $200,000. Seventy-four percent of the benefits of the third year tax cut and indexing go to taxpayers with incomes below $50,000. As a total, repeal would result in a massive $273.2 billion tax increase between fiscal 1983 and 1988.

As the President has said, it makes no sense to raise taxes just as we are coming out of recession. Nor does it make any sense to so unfairly place the tax burden on the backs of low and middle income families. We need more economic growth in this country that will put people back to work and increase our tax base. Repeal is a bad idea at the wrong time and place.

Another caution is in order. At a time in which we are facing high deficits it would be grossly unfair to repeal the tax provision requiring withholding on interest and dividends. Under withholding there is no tax increase on honest taxpayers; almost all of the revenue increase comes from taxpayers who are not paying the tax that they owe. Repealing withholding would result in a revenue loss of over $16 billion over the next five fiscal years. We can

hardly ask honest taxpayers to pick up this additional burden. Repealing withholding at this time would also send a message that the government does not take seriously the major effort initiated last year to insure better compliance with the tax laws in general.

Last year we were relatively successful in working with the Congress to achieve our goals of tax reform, but we were less successful in the area of outlay control. A major portion of the savings we had proposed in our original budget did not receive favorable action. This, along with much weaker economic activity than expected, has left us facing the prospect of large deficits even as the economy recovers.

The proposals in the FY-1984 Budget are directed at the crucial task of restoring noninflationary economic growth. This requires the preservation of the investment and work incentives provided by the tax reforms of 1981 and a reduction in the high deficits and interest rates which lie ahead unless corrective action is taken to bring government outlays under control.

The tax reforms already enacted will enable us to make good progress in rebuilding and modernizing America's plant and equipment as the recovery progresses. Incentives are in place to encourage saving and investment and to lower the cost of new machinery and structures. Taxes on American labor are coming down. These reforms will lead to a more productive, more competitive United States. The capital formation program will be financed by higher levels of personal saving, more generous capital consumption allowances, and higher retained earnings as profits recover from the current slump. These elements, plus state and local budget surpluses, form the Nation's savings pool.

Spending reduction will contribute to the recovery, and the recovery will contribute to deficit reduction. The deficit will fall as the economy advances, particularly if the recovery is a vigorous one. A strong recovery with 1-1/3 percent more real growth per year than in our forecast would bring the budget to near balance by 1988, provided we also curb the growth of Federal outlays.

However, if we fail to bring spending under control and if recovery is slow, we will face a deficit problem which is larger and longer-lasting than we can afford. In such case, the deficit could run in the range of 6 to 7 percent of GNP each year through 1988. Our tax reforms were designed to raise the private savings share, but still we would face

the possibility of draining off a large part of the pool of savings, leaving less available for new capital formation. Interest rates could remain high, and the recovery could stall.

This Administration is determined that deficits of such magnitudes will not come to pass. We came to office with a program of boosting the rate of capital investment in order to place the economy on a faster growth track, and we will not allow ourselves to be diverted from that goal. We will take whatever measures are necessary to narrow the deficit to acceptable levels.

- Preferably, all of the necessary narrowing of the deficit would come from the outlay side. Total Federal spending represents the amount of resources absorbed by the government at the expense of the private sector. This spending can be financed by both taxes and borrowing, which in either case amounts to a drain on private resources. Only through spending reduction will the credit market find itself in a more favorable position.

- In the event that the combination of economic growth and outlay reductions is not sufficient to narrow the deficit to acceptable levels in the out years, we are prepared to request additional revenue raising measures in those years. If the Congress chooses not to reduce spending, as we wish, then it is preferable to have the full cost of federal spending programs explicitly identified for the taxpayers who bear the burden of financing government. If additional revenues are needed, this Administration will do its best to structure the tax code in a way that minimizes disincentives for productive effort.

Our Budget Proposals

Spending reduction is crucial. Unfortunately, it has been difficult to achieve because of the built-in momentum of Federal spending programs. Consequently, we are proposing strong medicine. We, like a great many other nations in the world, have tried to live beyond our means. Now we must bring our spending into line with our productive capacity and strengthen the private sector which produces our national wealth.

The deficit reduction program that we propose contains four basic elements.

- The first is a freeze on 1984 outlays to the extent possible. Total outlays shall be frozen in real terms in 1984. The 6-month freeze on COLAs, as recommended by the Social Security Commission, is to be extended to other indexed programs. There will be a 1-year freeze on pay and retirement of Federal workers, both civilian and military. Many workers in the private sector have accepted freezes in their pay. Federal workers can also make a sacrifice, which may serve as an example for sectors of the economy that have not yet recognized the need for moderation in wage demands. As a final item of freeze, outlays for a broad range of nonentitlement progams will be held at 1983 levels.

- The second element of our budgetary program contains measures to control the so-called "uncontrollable." Laws have been so written that Federal payments are automatic to all those declared eligible. We plan a careful review of all such programs, taking special care to protect those truly in need.

- The third element is a cutback of $55 billion in defense outlays from original plans.

- Fourth is a set of proposals involving the revenue side of the budget, described below.

We are projecting receipts for the current year (fiscal year 1983) of $597.5 billion. For fiscal year 1984 we expect receipts to be $659.7 billion. The 1983 figure represents a decline of $20.3 billion from the fiscal year 1982 total of $617.8 billion. This decline, and indeed the absence of an increase in receipts in the range of $50-$70 billion, is explained in large part by the recession. As I have already explained, our economic projections throughout the remainder of the recovery period are cautious. If real GNP grows at a faster rate than we have projected, then receipts for the current fiscal year, as well as for subsequent years, will be somewhat higher than we are now projecting.

In 1984, as the recovery is well underway, receipts are expected to rise to $659.7 billion, an increase over 1983 of $62.2 billion, representing an annual growth of 10.4 percent. This will occur as profit margins recover and other income shares continue to grow.

For the other years in our forecast period (1985-1988) we project an average annual growth rate of receipts about 10 percent without contingency taxes (and 11 percent per year including contingency taxes), with receipts reaching the $1 trillion mark for the first time in fiscal year 1988. All of these projections assume the legislative proposals included in the President's Fiscal Year 1984 Budget are enacted. Receipts under existing legislation will also grow, but at a somewhat lower 9-1/2 percent annual average rate.

It is noteworthy that individual income tax receipts will continue to rise over the 1985-1988 period, but only as real income rises. Beginning in 1985, we will no longer collect hidden taxes in the form of bracket creep caused by inflation. Without the indexation provision of ERTA, individuals would pay $6 billion more in taxes during fiscal year 1985 alone, and about $100 billion more through 1988.

There has been a gradual upward trend in unified budget receipts as a percent of GNP, shown in the top line of Chart V. As shown in the bottom line of the chart, a major shift in the composition of receipts has been the rising share of social insurance and other payroll taxes to fund social security and other retirement benefits.

Major Tax Proposals

There is no proposed omnibus tax bill in the President's budget message. There are, however, eight major proposals concerning taxes.

First, we are endorsing the bipartisan social security plan with sufficient tax changes to ensure the future solvency of the social security trust funds and to restore the confidence of present and future retirees in this vital program.

We are also reintroducing, with some modifications, three proposals considered by this committee last year: the Caribbean Basin Initiative, the enterprise zone legislation to stimulate the economic improvement of distressed areas, and tuition tax credits to ease the double burden of families who send their children to private schools and pay local school taxes.

Next, the President has proposed three new tax initiatives: a jobs tax credit for the long-term unemployed,

a cap on the amount of employer-paid health insurance premiums that may be excluded from employees' taxable incomes, and a limited exclusion from tax for earnings on savings set aside for higher education expenses.

Last, the President has included in his budget message a contingency tax plan designed as a stand-by insurance program to insure additional tax revenue if deficits are projected to exceed two and one-half percent of GNP in 1986.

In addition to these eight specific tax proposals, the President has directed Treasury to undertake a careful study of the current income tax structure. We will be searching for ways to simplify the tax system, to make it fairer, and to remove tax obstacles to economic growth and expanding employment.

Let me now discuss some of the details of each of these proposals.

Social Security. As the President made clear in his State of the Union Address, the Administration strongly supports the bipartisan plan recommended by the National Commission on Social Security Reform. Although this Committee will be taking up all aspects of the proposal, I will concentrate today on just the tax aspects of the bipartisan plan. Three major Social Security tax changes are proposed.

First, there will be a slight acceleration of the scheduled increase in the payroll tax rate in 1984 and then again in 1988 and 1989. For 1984, an income tax credit will be provided to refund the increase for employees. Second, beginning in 1984 the self-employment tax rate will be made comparable to the combined employer-employee tax rate, with one-half of the new self-employment rate being deductible as a business cost in calculating taxable income. Third, single taxpayers with more than $20,000 and married couples with more than $25,000 of adjusted gross income from non-social security sources will be required to include 50 percent of their Social Security benefits in adjusted gross income subject to the Federal income tax. Any technical problem in designing the income tax changes will be worked out within the spirit of the bipartisan compromise.

Further, beginning in 1984, mandatory coverage will be extended to all new Federal employees and employees of nonprofit organizations. Also, State and local governments currently paticipating in the system will no longer be allowed to withdraw.

Together with the recommended changes in benefits, these tax changes will provide the necessary revenues to assure adequate funding for the Social Security system for many

years to come. Receipts of the Social Security Trust Funds will be increased by $9.9 billion in 1984, $11.9 billion in 1985, and $11.2 billion in 1986. The bipartisan plan will increase net Federal revenues in the Unified Budget by $8.2 billion in 1984, $5.8 billion in 1985, and $8.9 billion in 1986.

Reintroduced Proposals. As I have indicated, we will be reintroducing three proposals which we feel are quite important. The first of these, the Caribbean Basin Initiative, is the House-passed version of the legislation your committee considered last year. It contains two basic provisions. First, it allows U.S. income tax deductions for expenses incurred by taxpayers attending business conventions held in Caribbean Basin countries, provided that there is a bilateral agreement for the exchange of information required to carry out the tax laws of the U.S. and the designated country. This part of the initiative will encourage tourism, one of the principal economic activities of the region. Second, the Caribbean Basin Initiative provides that all excise taxes collected on rum imported into the United States, wherever produced, will be paid to the treasuries of Puerto Rico and the U.S. Virgin Islands. Under current law, only taxes collected on rum produced in those territories and transported to the United States are returned to Puerto Rico and the U.S. Virgin Islands. The purpose of this provision is to insure that Puerto Rico and the Virgin Islands will not lose excise tax revenues as a result of the duty-free treatment of rum produced elsewhere in the Caribbean Basin.

The provision allowing the deductibility of certain convention expenses will be retroactive and apply to any qualified convention expenses incurred after December 31, 1982. The transfer of excise taxes on rum will become effective April 1, 1983. The Caribbean Basin Initiative is estimated to reduce receipts by less than $15 million per year.

The second proposal we are reintroducing is the enterprise zone legislation. This proposal is similar in all basic elements to the proposal we made last year, except for the effective dates, and very similar to the bill reported out of this Committee in the last session. This proposal is designed to create a productive free-market environment in economically depressed areas by reducing taxes, government regulations, and other government burdens on economic activity. The program includes Federal tax incentives specially designed to encourage the formation of capital and the creation of jobs, with special emphasis on hiring disadvantaged workers. This is a fresh approach to promoting economic growth in inner cities. Instead of relying heavily on government grants which often have proved inefficient and ineffective, the enterprise zone approach concentrates on freeing private enterprises to produce, create jobs and expand.

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For a three-year period beginning in 1983, the Secretary of Housing and Urban Development may designate up to 75 small areas as enterprise zones. No more than 25 zones will be designated each year. For zones designated in 1983, the tax incentives will become effective January 1, 1984. The enterprise zone tax incentives are estimated to reduce receipts by $0.1 billion in 1984, $0.4 billion in 1985, $0.8 billion in 1986.

The Administration also is reintroducing a proposal to allow taxpayers a credit against their income taxes equal to 50 percent of tuition costs for each child in a private elementary or secondary school. The provisions of this proposal are identical to those contained in the Senate Finance Committee bill of last year except that the income range over which the credit will phase out is $40,000 - $60,000 of adjusted gross income rather than $40,000 - $50,000 of adjusted gross income. The maxium credit per child would be $100 in 1983, $200 in 1984 and $300 in 1985 and thereafter. The Administration supports the strong anti-discrimination provisions passed by the Senate Finance Committee last year.

This proposal would be effective for tuition expenses paid on or after August 1, 1983. The proposal is estimated to reduce receipts by $0.2 billion in 1984, $0.5 billion in 1985, and $0.8 billion in 1986.

New Tax Initiatives. There are also three major new tax initiatives in this year's Budget. First, to help the long-term unemployed find meaningful jobs in the private sector, the Administration proposes a new tax credit for employers who hire individuals after they have exhausted their regular and extended unemployment insurance benefits. The tax credit is part of a plan to modify the present program for Federal Supplemental Compensation (FSC), turning that program into an effective hiring incentive. Rather than simply offering additional payments to those already out of work for a long period, this proposal will allow job seekers to convert FSC benefits to job vouchers they may offer to prospective employers as a hiring incentive. When the employee is hired, these vouchers entitle the employer to a credit against taxes, including their unemployment insurance taxes. After six months, the option to receive FSC benefits will end, but the tax incentives for hiring the long-term unemployed will continue until April 1984. The value of the tax credit will be equal to the benefits available under the FSC program. The proposed tax credit is estimated to reduce receipts by a negligible amount in 1983, $0.2 billion in 1984, $0.2 billion in 1985, and $0.1 billion in 1986.

The Administration also proposes to limit the amount of employer-paid health insurance premiums that may be excluded

from income and social security taxes. This exclusion creates inequity between employees receiving equal compensation, but paying quite different amounts of tax because of different amounts of employer-provided health benefits. The exclusion has also encouraged elaborate health insurance plans as a substitute for taxable compensation. Over the years this substitution has eroded the income tax base and contributed to the rising cost of medical services. Effective January 1, 1984, the proposal will require employees to include employer-paid health insurance premiums in taxable income to the extent that they exceed $175 per month for family plans and $70 per month for single plans. Employer-paid premiums below these amounts and premiums paid under current (but not future) union contracts will continue to be excluded from taxation.

In 1984, less than 18 percent of employees will be affected by this proposal, but the change will be minimal even for those who are affected. For example, an employee receiving $30,000 in cash compensation and $2,400 in health insurance benefits pays about $800 less in tax than another employee who receives equal compensation in the form of cash. Under the proposal, the employee receiving health insurance will still pay almost $700 less in tax than the employee with equal compensation in the form of cash. At the margin, however, the employee with substantial health coverage would pay $1 of after-tax income for each additional $1 worth of health insurance rather than about 67 cents, as under current law.

This proposal will improve the fairness of the tax system and help restrain future health care costs. It will increase receipts by an estimated $2.3 billion in 1984, $4.4 billion in 1985, and $6.0 billion in 1986.

The President's third new tax initiative is the establishment of Education Savings Accounts to help families pay future higher education expenses of their children. Taxpayers will be permitted a tax exclusion for the earnings on savings deposited in these special accounts. The maximum annual contribution to these accounts will be limited to $1,000 per child. This ceiling will be reduced five cents for each dollar that the taxpayer's adjusted gross income in the prior year exceeds $40,000, thus no deposits could be made by families with more than $60,000 of income. Taxpayers with incomes between $40,000 and $60,000 will be eligible only for reduced deposit amounts.

Expenses may be paid out of savings held in these accounts for tuition and room and board of full-time dependent children enrolled in undergraduate degree programs in schools that do not follow a policy of racial discrimination. These expenses must be paid directly to the university or college. Savings withdrawn for any other

purpose will be assessed a penalty, except in the case of the child's death or when the savings are needed to pay for certain unusual medical expenses incurred by the child.

In order to encourage families to begin saving early for a child's higher education, deposits may be placed in these special savings accounts on behalf of any dependent children under the age of 18. In no case may an account be kept open for a child over the age of 25.

The following example illustrates how the exclusion from tax for earnings deposited in these accounts will help families set aside funds to enroll their children in colleges or universities of their choice. For a family with about $30,000 of income and making maximum contributions to accounts earning 10 percent per annum for two children, the tax reduction will be about $50 in the first year, $350 in the sixth year, and about $800 in the tenth year. Over the full 10 years, an additional $4,800 would be available to meet the qualified education expenses of the family's children.

If, in a future year, the taxpayer's adjusted gross income rises above $40,000, he will be eligible only for reduced deposit amounts, but the exclusion of income on previous deposits still will be allowed in full.

This exclusion for earnings on savings set aside for higher education is proposed to be effective January 1, 1984. It is estimated to reduce receipts by a negligible amount in 1984, $0.1 billion in 1985 and $0.2 billion in 1986.

Contingency Tax. Finally, the President has proposed a contingency tax plan designed to raise revenues of about 1 percent of GNP in the event that, after Congress has adopted the Administration's spending reduction proposals and structural reforms, there is insufficient economic growth to reduce the deficit below 2-1/2 percent of GNP. The contingency tax plan would go into effect on October 1, 1985, provided that the economy is growing on July 1, 1985 and the forecasted deficit for fiscal year 1986 exceeds 2-1/2 percent of GNP. The contingency tax plan is an insurance program. It is important to have a plan in place so that everyone will know that we will not tolerate a string of deficits that would exceed 2-1/2 percent of GNP. Chart VI shows the effect on the deficit that the contingency tax would have if it were implemented. It also shows how the budget picture would be altered by a much stronger expansion. The high growth deficit path shown reflects the assumption that real GNP increases 1-1/3 percentage points faster than in the official forecast path, starting with FY-1983. Such growth would be in line with economic performance from the end of 1960 to late 1966.

The contingency tax plan would contain two elements, each raising about half of the revenues that may be required. One element would be a temporary surcharge of 5 percent of taxes otherwise paid by individuals along with a similar additional tax on corporations. The other element would be a temporary excise tax on domestically produced and imported oil, designed to raise revenues of about $5 per barrel. The excise tax would apply to imported oil products as well as imported crude oil.

The contingency tax alternative shown in the budget raises $146 billion over the 36-month period beginning October 1, 1985. The specific contingency tax plan we will be sending to Congress for adoption this year will be designed to raise revenues of about $130-150 billion over a temporary period of up to 36 months.

About 85 percent of the $5 income surcharge will be paid by individuals. The remainder will be paid by corporations. This surcharge will not change the distribution of taxes. It will be 5 percent of each person's tax. For example, a family of four earning $10,000 would pay a surcharge of $15, or 5 percent of its $291 tax liability. At $50,000 of income, the family of four would pay a surcharge of $358, or 5 percent of the $7,165 in tax it would otherwise owe. At $100,000 of income a family of four would pay a surcharge of about $1,100.

The $5 per barrel oil excise tax has been selected for the other component of the contingency tax plan because it raises the needed revenues in a way that has a very broad impact on all taxpayers and all sectors of the economy. We are proposing no exemptions from this tax because such exemptions would reduce significantly the revenues needed if the contingency tax plan becomes effective. The $5 tax on a barrel of oil would translate roughly into a 12 cent increase in the price of a gallon of gasoline and a 12 cent increase in the price of home heating oil. Both of these price increases have been more than offset by recent reductions in the world price of oil. For a typical car owner who drives 10,000 miles a year, the 12 cent per gallon increase would amount to a $62 annual increase in the cost of gasoline he consumes. For the average home heated by oil, the 12 cent per gallon increase in the cost of home heating oil will mean an increase in fuel costs of about $60 a year.

A strong, sustained economic recovery together with a determined program of restraint on domestic spending will bring down the deficits without activating the contingency taxes. We all fervently hope to avoid these taxes, but our markets and decisionmakers need the assurance that those standby taxes will bring. This assurance and spending restraints are important keys to sustained recovery.

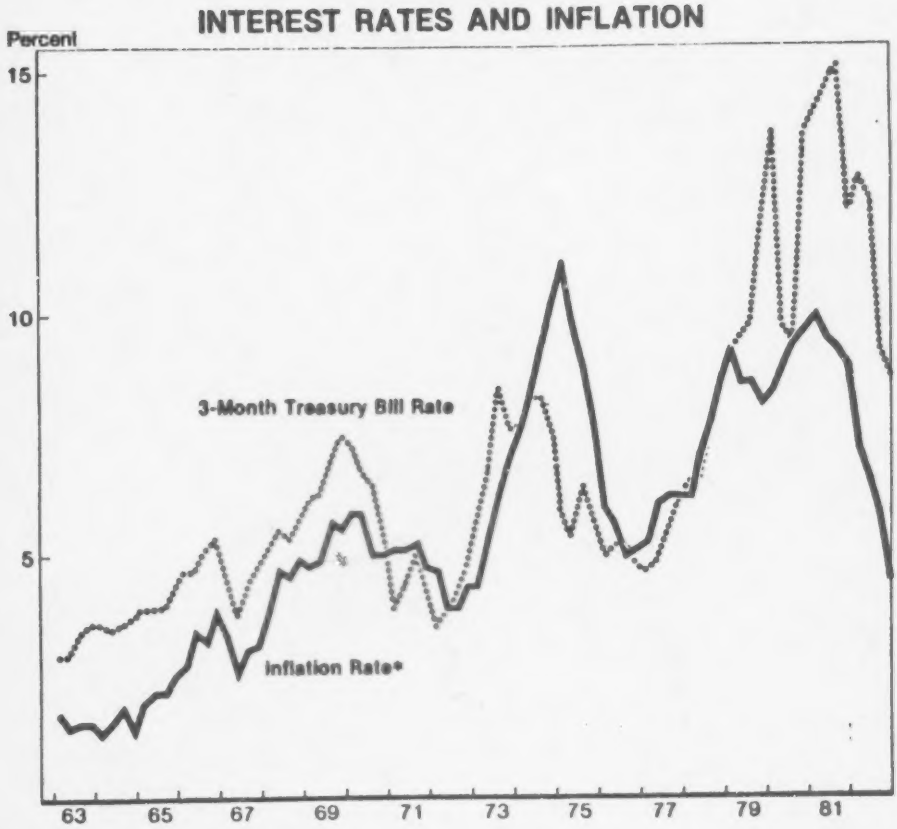
Conclusion

If all of the Administration's budget saving proposals are enacted, we will reduce the projected deficits by a total of $580 billion over the next 5 years, or by $2,400 for every man, woman, and child in the United States. The deficit as a share of GNP will be down to about 2-1/2 percent in 1988 from the 6-1/2 percent we expect this year. Total outlays will grow by only 1.9 percent per year in real terms over the next 5 years, compared with a bloated 3.9 percent real growth between 1977 and 1981.

We are confident that the deficit reduction program contained in this realistic budget is the right program for the economy at this critical juncture. The most important signals we can send the economy are spending restraint, deficit restraint, and a commitment to noninflationary economic growth throughout the decade. This is the program we are recommending. Together with the Congress, we can make it work.

Chart I

INTEREST RATES AND INFLATION

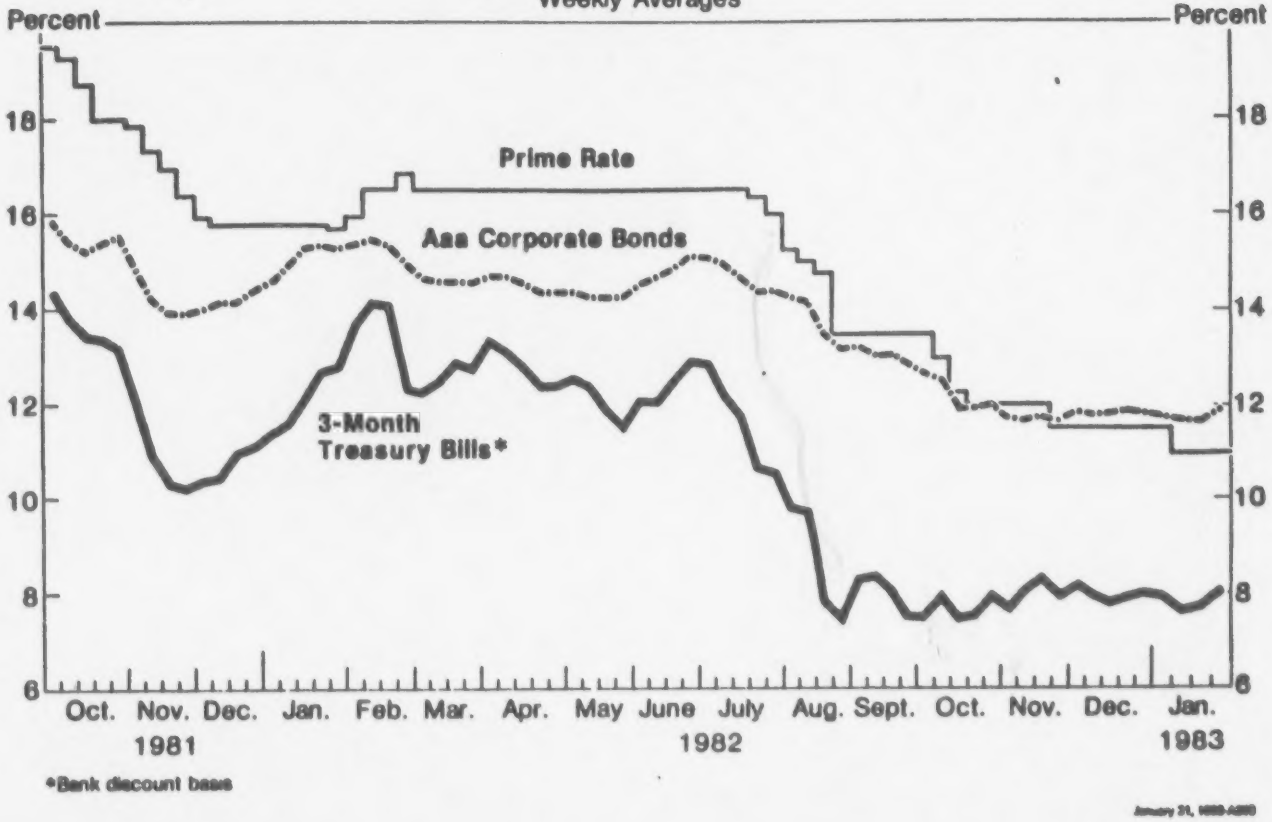


* Growth from year earlier in GNP deflator. Plotted quarterly.

Cha

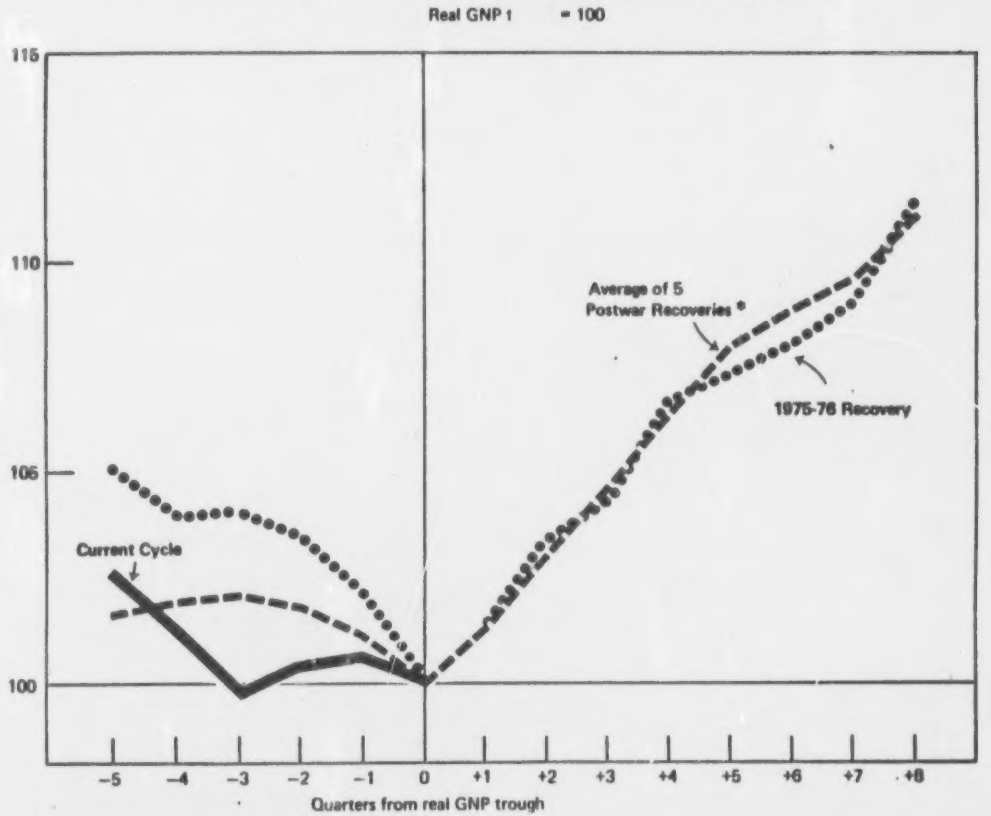
INTEREST RATES

Weekly Averages



*Bank discount basis

THE PATH OF POSTWAR ECONOMIC RECOVERIES

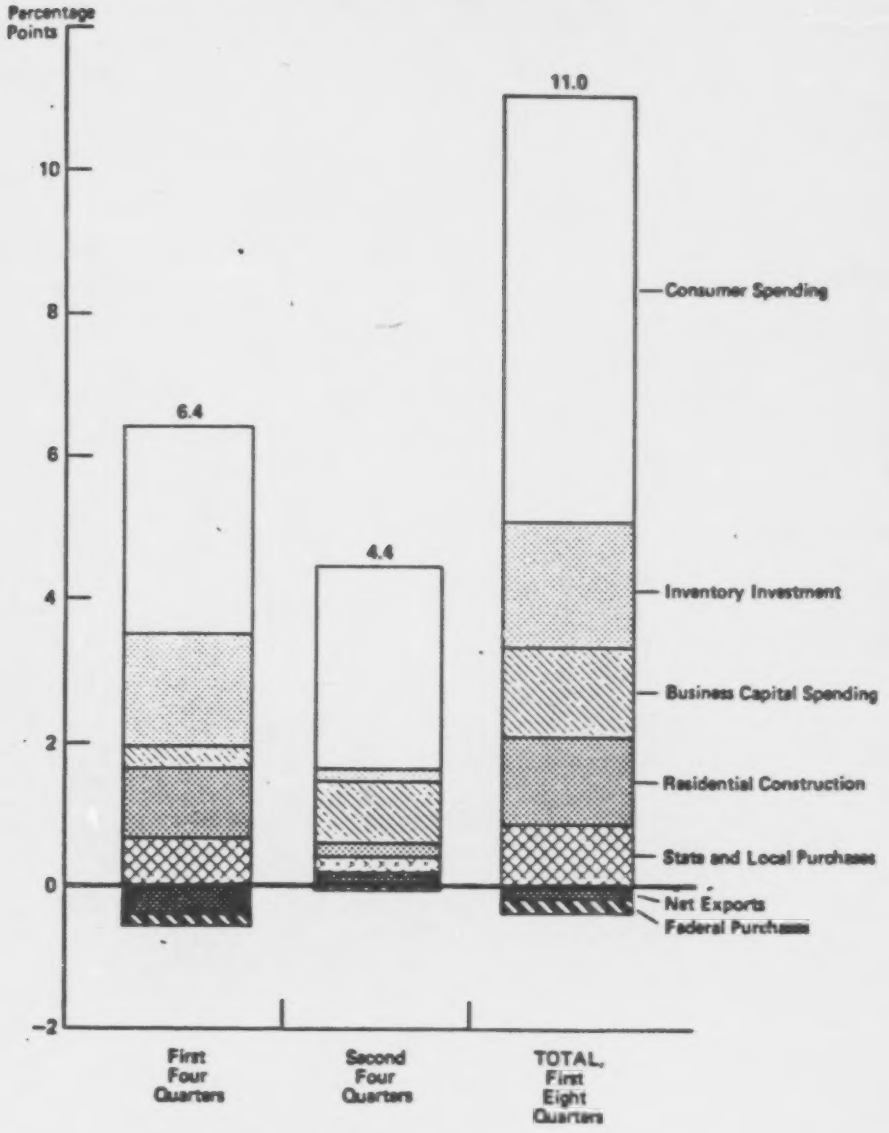


* Postwar recoveries excluding the Korean War period and the short-lived 1980-81 recovery.

January 25, 1983-A210

Chart IV

CONTRIBUTIONS TO A TYPICAL RECOVERY* BY REAL GNP COMPONENT

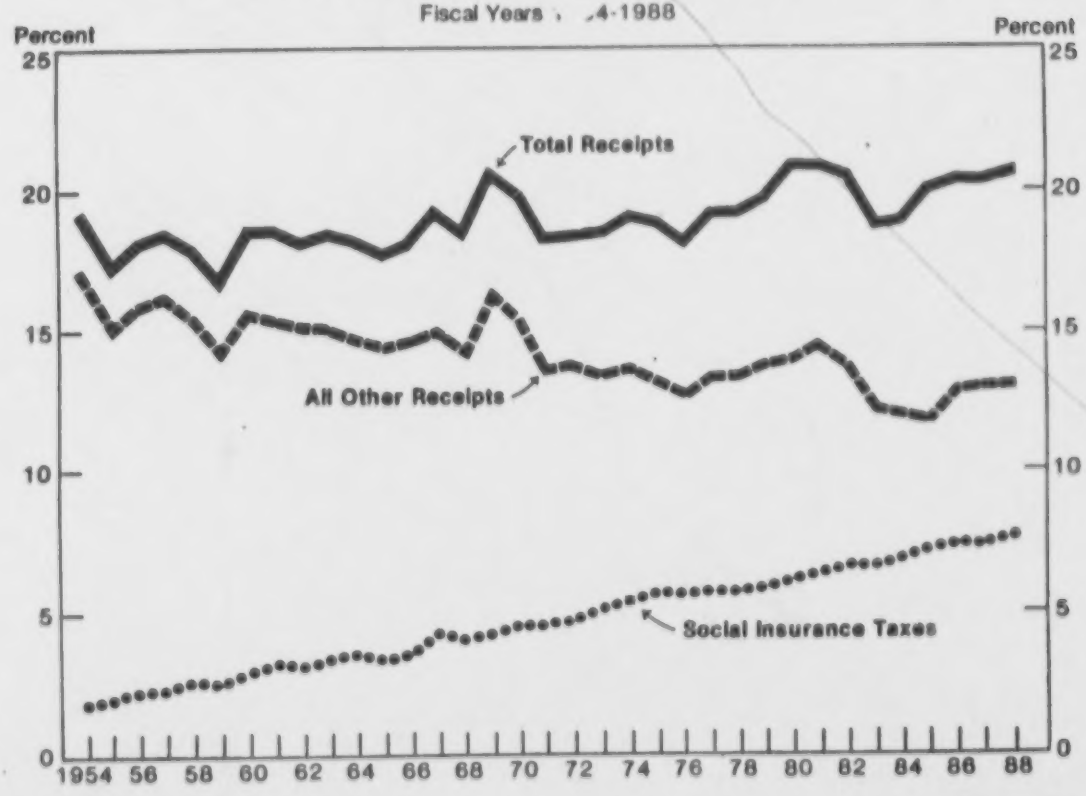


* Average of postwar recoveries, excluding the Korean War period and the short-lived 1980-81 recovery.

January 21, 1983-A213

UNIFIED BUDGET RECEIPTS AS A PERCENT OF GNP *

Fiscal Years 1954-1988

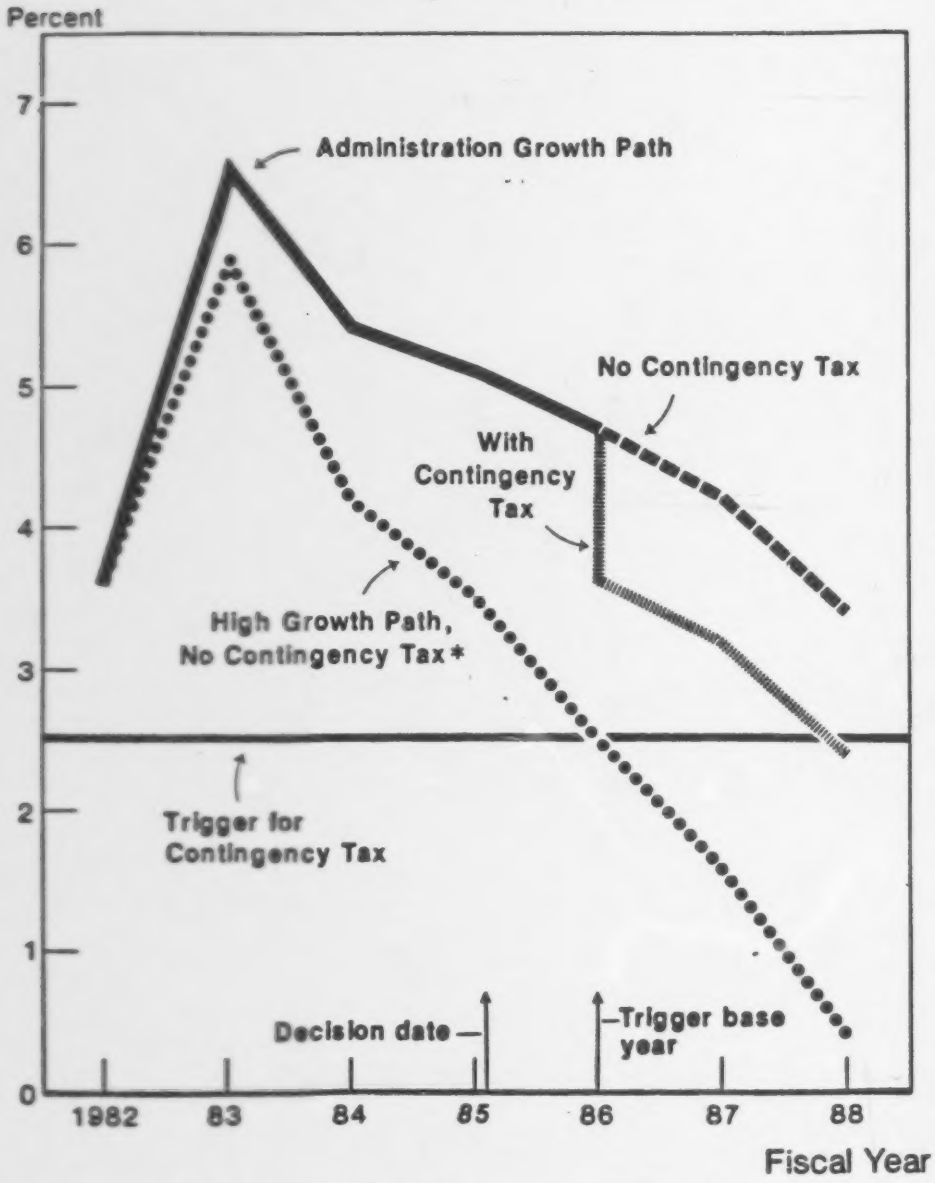


* Receipts include contingency taxes.

January 28, 1983-A216

Chart VI

THE DEFICIT AS A SHARE OF GNP



*Higher growth than the official path by 1-1/3 percentage point starting fiscal year 1983.

January 28, 1983-A214

The CHAIRMAN. Thank you very much, Mr. Secretary.

Let me explain to the members. I indicated to the Secretary earlier that I knew many were probably tied up in the prayer breakfast traffic, and so we proceeded to hear his statement. We will abide by the early-bird rule as far as questions are concerned.

I have a statement that I would like to make a part of the record. And others may wish to read their statements at the appropriate time.

[The statement of Senator Dole follows:]

STATEMENT OF SENATOR DOLE

I would first like to welcome Secretary Regan, to our initial hearing on the administration's proposed budget for fiscal year 1984. Let me say at the outset that I think this is a budget we can work with. That does not mean that Congress will not need to make changes—in some areas, substantial changes. Certainly, I do not agree with every proposal, and other Members may have much stronger objections than I do. But Congress must look critically at the President's budget if it is to fulfill its obligation to control the deficit.

I believe this budget has much to commend however. First, it is based upon economic projections which virtually no one considers too optimistic. If anything, the growth estimates in the first year are likely to prove too modest. It would be a pleasant change to find deficit projections falling as a strong recovery takes hold. Second, the administration has dropped its requests for deep cuts in some domestic programs because those cuts were unsuccessful last year. There is also increased funding for unemployment assistance, training and employment services, and some education programs. This does not mean that other proposals for cuts in discretionary spending programs and in means-tested entitlements will be welcomed by all in Congress. But the administration has demonstrated some flexibility in the domestic spending area. Third, the 6-month cost-of-living-adjustment delay represents an essential first step in controlling the escalating cost of non-means tested entitlements. Finally, the budget recognizes that even with recovery underway and significant budget savings achieved, it may be necessary to raise additional revenues to close the deficit gap.

So while many will object—as I do—to some of the specifics of spending reductions and the stand-by tax proposal, I think we can all agree that this budget aims us in the right direction. It provides for a slow, steady reduction in the Federal budget deficit over the next 5 years. While many would put a different mix in the budget, we must do at least as much as is proposed to bring the budget nearer to balance. Deficits of $230 billion, rising to over $300 billion by 1988, are unacceptable. I recognize that many economists are saying that large deficits this year and next are not such a bad thing; that a little deficit stimulus will give the economy a shot in the arm as it moves into the recovery phase. That may be true. But a $230 billion deficit may be overdoing it a bit, I think.

In any event, we cannot wait until next year to take action to bring down those looming, "out-year" deficits, which universally are recognized as damaging. As the economy recovers, the true cost of the Federal Government claiming a major share of savings that would otherwise be channeled into productivity enhancing investment will become evident. If we do not bring down the deficits this year, financial markets will remain unsettled and the steady decline in interest rates over the past 6 months, especially long-term rates, will come to a premature end. Once again, the private sector looks to us for leadership.

BUDGET PROCESS SHOULD PROCEED WITHOUT DELAY

We now are at the threshold of an economic expansion. Almost all of the economic indicators point upward, and we can assist this recovery by enacting a package of deficit reduction measures as quickly as possible. An early budget resolution would help to calm these fears, allow interest rates to continue downward, and give the budding recovery a real lift. I understand the Senate Budget Committee is aiming for adoption of a budget resolution 4 to 6 weeks in advance of the target date of May 15. I fully support this effort. If we continue with a spirit of bipartisan cooperation, there is no reason why we cannot have the budget in place early in the year.

ALL SPENDING MUST BE SCRUTINIZED

Last year we realized that, in order to be successful, a deficit-reduction package would have to be seen as fair. I believe that the administration has tried to address this problem of equity by proposing entitlement reforms, a delay of COLA's, as well as some defense cuts. Many of us believe that further defense restraint will be necessary. In any event, we need to take another look at this as well as all other programs.

REVENUE PROPOSALS

Apart from the revenue provisions of the bipartisan social security plan, the tax proposals in the President's 1984 budget may be broken down into two categories. First, there are tax policy changes that are designed to meet a particular social objective such as the cap on employer-paid health insurance premiums, "enterprise zone" tax incentives for distressed areas a new tax credit for employers who hire the long-term unemployed; tax incentives for education savings accounts, and tuition tax credits. Most of these proposals are quite familiar to the members of this committee. Enterprise zones and tuition tax credits both were reported by the Finance Committee last year, and the committee has looked at jobs tax credits several times so it would seem to me that we are ready to move fairly expeditiously on this particular tax agenda.

The administration also proposes deficit reduction measures pure and simple—specifically, the "standby" tax increase that would be triggered in fiscal year 1986 if the deficit is not brought down to 2½ percent of GNP and if Congress adopts the administration's other deficit reduction measures. As I understand it from the most recent descriptions we have heard, this standby tax would raise about $46 billion in fiscal year 1986 through a 5 percent income tax surcharge and an oil excise tax.

Many of us have criticized a "triggered" tax increase that provides no certainty and because it is difficult to forecast so far in advance. In addition, the particular revenue measures that would be triggered—a temporary increase in marginal tax rates and an energy tax—may not be the best policy that could be devised. So we will want to have some input on the revenue-raising measures that emerge from this session of Congress. But revenues will have to play a role, and we are prepared to work with you and with anyone else who can play a constructive part.

Some of us do agree with the President that there is really no justification for going back on the promises we made to the American people when we passed the third year of the tax cut and indexing. We will compromise where we have to accomplish our task, but we ought to think very carefully before tampering with these major protections for the average taxpayer—the fellow we forget too often in Congress. Let us move ahead and make the necessary tax policy changes to cut the deficit: But let's be sure they are good policy, fair and equitable, and openly agreed to the road ahead.

We can be confident of economic recovery this year, and some relief from the high unemployment that has created so much hardship. If the recovery turns out to be stronger than expected, that is a sruprise we can live with. It would certainly make our job easier. But we cannot ignore the importance of fiscal policy in determining the strength and duration of the recovery. The Congress will also help to determine whether it will follow the path of past recoveries and burnup in the fires of inflation. If we can convince the financial markets that the Federal Government is serious about reducing deficits, there is a good change for a sustained, noninflationary recovery.

But let the record be clear: Even with strong economic growth, the deficit problem will not go away. Even as we reach full employment in 1988, according to the President's economic forecast current policy would leave us with a deficit of over $300 billion or 6 percent of GNP. Of course, with that kind of imbalance, it is highly unlikely that the economy would reach full employment. We have to begin working now to eliminate that structural deficit.

This budget starts us in the right direction. It is an honest budget. It is credible budget. And it faces up to the tremendous fiscal policy challenge in the years ahead.

Mr. Secretary, we look forward to your presentation of the President's fiscal year 1984 Budget.

Table 3.-Effective Tax Rates on U.S. Source Income
All Corporations With Income and Corporations
With Under $1,000,000 of Assets, by Industry, 1972

Industry 1/	All corporations: Industry rank	All corporations: Effective tax rate	Corporations with under $1,000,000 of Assets: Effective tax rate	Corporations with under $1,000,000 of Assets: Corporations included
		Percent		
Manufacturing not elsewhere classified	1	42.0	32.3	86.2
Paper and allied products	2	38.4	32.4	79.5
Credit dealers, brokers, insurance agents	3	38.3	29.0	95.1
Wholesale and retail trade	4	38.0	32.0	94.9
Communications	5	36.1	27.6	79.6
Electric, gas, and sanitary services	6	35.3	28.9	89.8
Lumber and wood products (nonfurniture)	7	34.6	32.2	87.5
Primary metals: ferrous	8	33.7	33.2	75.8
Contract construction	9	33.4	28.4	95.2
Services	10	31.6	26.5	97.6
Transportation	11	30.1	26.6	94.3
Primary metals: nonferrous	12	29.4	25.4	72.6
Real estate	13	28.9	26.2	94.7
Agriculture, forestry and fisheries	14	28.1	23.4	94.4
Unclassifiable businesses	15	27.7	26.1	98.8
Mining not elsewhere classified	16	25.6	22.4	76.9
Petroleum and natural gas	17	24.7	23.8	85.5
Coal mining	18	19.4	24.7	84.3
Banking	19	18.6	26.8	6.7

Office of the Secretary of the Treasury
Office of Tax Analysis

1/ See Appendix for detailed industry categories in groupings shown here.

The CHAIRMAN. I am pleased you mentioned withholding on interest and dividends in your statement. We have been subjected to a heavy campaign by credit unions and the banks and, to a lesser extent, the S&Ls concerning withholding on interest and dividends. There has been a lot of misinformation, published maybe not intentionally, but a lot of it published, such as big ads in newspapers and the like.

Do you believe that the revenue estimate that we assumed when we enacted this, I think it was $10.5 billion over 3 years, do you still stick by that estimate?

Secretary REGAN. I certainly do, Mr. Chairman. I think that the revenue projections that we had last year are still valid.

The CHAIRMAN. There have been a lot of efforts by some to indicate this is a new tax. Is withholding a new tax? It was just understood it was to get to people who had not paid the tax to comply, to join the other honest taxpayers who have.

Secretary REGAN. That is true. Recall what we said last year, when we were describing this, Mr. Chairman. We said then that taxpayers were failing to report about 20 billion dollars' worth of interest and dividends according to IRS field studies on this subject. We believe that if we start to collect the tax due on this income at the source, we would get the proper tax share of this amount. And the proper tax share, figuring 20 to 25 percent as an average effective tax rate on that $20 billion, would amount to $4 to $5 billion per year that we are now not collecting.

The CHAIRMAN. There have also been some gross exaggerations as to the effect withholding will have on the effective yield on savings and interest and dividends. Our staff estimates the effect on yield will be minimal, less than 50 cents per year on $1,000 of savings at current money market rates. Has the Treasury Department made any analysis of this?

Secretary REGAN. Mr. Chairman, let me take as an example, a 9-percent yield—which would be within the ball park figures of an average yield this year on a $10,000 investment. Interest withholding would reduce the gross yield from $900 to $895. In other words, on 10,000 dollars' worth of savings, we are talking about $5 per year as the reduction in gross yield that we would collect in advance.

The CHAIRMAN. And I think there is some legitimate concern. I have had a chance to visit with many smaller bankers, and I think they do have some concern about startup costs. And there ought to be some areas that we address, and we have tried to do that. I just wish that the banking community would spend their time and money trying to make the law work instead of trying to repeal it.

Our preliminary staff analysis suggests that the banking industry has an extremely low effective tax rate, one of the lowest effective rates of any major American industry. Do you think we ought to be examining some of those loopholes utilized by banks and credit unions? [Laughter.]

Secretary REGAN. Far be it from me, Mr. Chairman, to suggest these things. But I do recall last year we did look into some of these bank taxes; for example, such items as the amounts that they are able to set aside as bad debt reserves, which to some analysts seems to be a bit larger than normal.

I also recall that we looked at the fact that banks can borrow money to buy tax-exempt municipal bonds and then get tax-free interest income. This, plus other tax shelters—including the ability to buy ITC's and the like—keeps their effective tax rates down well below 10 percent.

The CHAIRMAN. Well, in fact, we were told last year that the top 18 banks paid a tax rate of .03 percent. And I assume that is an average. Some probably did not pay any taxes. But that is not a very high average. And we are looking into that. We think we ought to have them focus on something that might really concern them.

And we have a staff study underway, and we will be having hearings on that. We are also looking into credit unions. They do not pay much tax. They are very concerned about a bankruptcy provision that happens to be in another committee that we are trying to work with them on slowly. [Laughter.]

And so we are also about to bail out some of the larger banks with the International Monetary Fund. I understand the administration supports that. I do not know why we should act on that legislation while the banks are trying to destroy what we accomplished last year; broadening the base of the tax system, trying to close some of the loopholes.

And I would hope the administration would go easy on that legislation until after July 1. Is there any reason to move on it before then?

Secretary REGAN. No. We are asking that when we settle on the amount for our IMF request, the effective time period be December 31, 1983. So passage by the Congress anytime prior to that date would assure that.

The CHAIRMAN. Well, is it safe to assume that if in fact they were successful in repealing the interest and dividend withholding provision, that we might attract a veto?

Secretary REGAN. That is what I would recommend to the President. I, of course, cannot commit the President to any particular action, nor would I know the circumstances under which any given bill would arrive on his desk. But at this point I would certainly recommend a veto.

The CHAIRMAN. Well, I know the President has a special interest in this. In fact, if you remember at one time we had a gas tax in the tax reform bill, and he indicated that there ought to be other things we could do at that time. And one option was withholding. So I know of his interest in that, and I hope it continues, because ours will continue.

It seems to me if we start dismantling what we did in 1982, we also will have the restaurant people in trying to repeal the tip provision. We have the truckers, some creating violence, trying to repeal the gas tax. And it seems to me that if we start dismantling the program, we might as well go all the way.

So I am pleased to have your strong comments. And I would just finally say that it also seems to me, and maybe Treasury is working on this, that rather than to just say we ought to have a tax increase—and I am not in total agreement with the standby trigger, and contingency tax—we ought to continue to look at ways to broaden the base.

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There are still some rather large loopholes that I believe we might address in the outyears, and I assume that Treasury will be cooperating with us to try to specify or at least target some of those that we might address.

Secretary REGAN. Well, we would be very happy to share any information we have, Mr. Chairman. And we would be happy to study these things with the committee.

The CHAIRMAN. I do believe that broadening the base, that is essentially what the President has in mind when he talks about tax simplification, trying to eliminate some of the complexity. We are being told by IRS that there is still going to be $120 billion in noncompliance where people are not even paying taxes they owe. And I would hope that we might first of all address the noncompliance areas and, second, the base-broadening areas before we have a surcharge or whatever in the outyears. And as I understand, you have yet to choose between a surcharge equal to 5 percent of tax and a surcharge equal to 1 percent of taxable income.

Secretary REGAN. Well, for purposes of this budget, we have made the 5-percent surcharge on tax liability. We think this is the fairest way to do it because with a 1-percent surtax on taxable income, the increased burdens would fall more heavily on those at the low end of the tax scale than on those at the upper end. So we think that an across-the-board 5 percent on tax liabilities—5 percent on $200 of tax is $10, 5 percent on 2,000 dollars' worth of taxes is $100, and so forth, is the fairest way to go.

The CHAIRMAN. Thank you, Mr. Secretary.

Senator Wallop.

Senator WALLOP. Thank you, Mr. Chairman.

I am glad to hear our chairman express some reservations about the standby tax proposals, because I have grave reservations as a matter of philosophy. I understand what you are trying to get, and I understand the signal that you are trying to send.

But I wonder if it does not send more than one signal. The first part of it would be this: Why would I, although I must say that life is a great deal easier after November than it was before, but why would I as a Senator take the heat passing a tax and then get no immediate revenue benefit from it? And so that somebody down the road, taking a look, and assuming all those trigger mechanisms that you have have been enacted and the Congress has been "responsible," and you still have this deficit?

Why not make Congress at any time choose between further cuts and more revenue? Why would I relieve somebody down the road from the obligation of making that choice when it came down to a hard one?

Secretary REGAN. What we are trying to do here, Senator, is send a signal to the money markets. You know as well as I do that in medium- and long-term bonds there is now a high rate of real interest, much higher than in previous times in our economic history.

When you ask why those real rates of interest are high, you find that they are high because people who are large buyers of U.S. Treasury obligations or other types of market instruments are afraid that we are going back into an inflationary period, and they are afraid of that because they hear of these high deficits.

The current services figures go from $230 billion to $300 billion, unless something is done either in the way of further spending cuts or tax increases. We are suggesting spending cuts, even though spending cuts, which we think are doable and that the Congress can agree with us should be done, still do not bring us down that far.

Now, there are ways that none of us can see, I would daresay, beyond the first quarter of this year, if indeed that far, with any degree of clarity. We do not know what is going to happen in those outyears. We are saying that this economy could recover faster than we are saying. If it hit the average as I showed on my charts, there we would be no need for the contingency tax.

Also, there will be three sessions of the Congress prior to the time of any contingency tax. Spending may be cut more drastically than we are forecasting.

If either of these things were to happen, the deficit would be less than 2.5 percent of gross national product, and we would not suggest tax increases under those circumstances.

Senator WALLOP. But, Mr. Secretary, there are two signals going there, which is one of the things that is troubling me. One is the signal of uncertainty. And one of the things that we tried to do with the original tax proposal of the President—and I recall that the Congress spent a good deal of time adding its own plums to that pie over and above what the President asked for--but we did seek to provide some certainty and some ability to plan investments.

Now, how would you as a corporate head—not in a Wall Street firm but of a manufacturing firm as somebody who is really looking, am I going to invest my money—now make that decision on the basis of a tax that may or may not be instituted by Congress that may or may not be responsible?

Secretary REGAN. We are taking the other side of the coin. We are saying enact the tax now so they will know with certainty that if certain things do not happen——

Senator WALLOP. That is what I was afraid you were going to say. The certainty is the tax is going to take place.

Secretary REGAN. Right.

Senator WALLOP. Then why not enact it right away? I mean if it is going to be a certainty that it is there, why should we do this thing?

Secretary REGAN. I will tell you why. I think we are now coming out of the recession. We are on the threshold of recovery. We think that a 1983 tax increase would be self-defeating. As a matter of fact, that is why we are pumping so heavily for keeping the tax cut due on July 1 in place. This is a well-known stimulative to the economy to have a tax cut at the time that you are coming out of a recession. We think even 1984 is not a practical year to ask for a tax increase. Accordingly, 1985 is the first year in which this can be done.

But, believe me, those same money market people we are talking about, and the like, will not take an asterisk in the budget and say that a future Congress might increase taxes if these deficits got too high.

Senator WALLOP. Am I to say that unless there is a palace coup, to quote a famous man, we will be here next year, and maybe then we would be able to do that? Congress spends a good deal of time paying more rhetorical bases to the god of deficits than it does anything about it.

And I would just point out for the record that there is no supply-side test that is yet on the record anywhere. People who are talking cite the failure of England under the Thatcher government. Taxes as a percentage of real GNP have risen 3 percent in the years that Prime Minister Thatcher has been there.

If one were to be entirely cynical about life, you could say the reason we are finally on the threshold of recovery is because this is the first year of real tax cut. It is probably no more beneficial than the arguments that are being used against it, but it is just as valid as those are.

I would hope that we would take a look at the test that the chairman said, try to find those people who owe taxes and are not paying them, rather than jump into the well and take those people who pay their taxes year in and year out dutifully and on time and promptly simply because we know where they are and the computer can identify how much we would get by hitting them once more.

The CHAIRMAN. Senator Bentsen.

Senator BENTSEN. Thank you very much, Mr. Chairman.

Mr. Secretary, the objectives, I think, of reducing taxes were worthwhile objectives. I think the objective of increasing defense force is something that had to be done, and the slowing down of the money supply; but to have done all three at the rate at which they were done to give us the tightest money in 20 years, as the Federal Reserve did, and to increase defense forces at this rate and then to cut taxes by 25 percent over 3 years, there is no way this economy could digest it. It was overloading the system. And we have ended up with the most horrendous deficits this country has ever seen.

Now, you stated before the Joint Economic Committee that we really would not see an increase in economic recovery and a return to the kind of prosperity we wanted until we got long-term rates down to single digit. Yet, the most secure Treasury notes, the 10-year notes, on the estimate of the administration itself, will not drop below 10 percent before sometime in 1984.

Now, to say that we are going to increase taxes but at some date in the future is not facing up to the realities of the problem. If we are going to get these long-term rates down, then we must bring that deficit down and bring it down substantially. And as one who voted for that tax cut, when we meet these kinds of conditions, then I think that we have to say that we cannot afford that tax cut, and we have to make a major move on cutting down that deficit.

Now, I saw your statement before the committee—in fact, I saw it on the television—where someone asked you in effect why wait until 1985; why not do it sooner? And your words added up to well, we have got an election in 1984, and need I say more.

I think you should say more. I do not think we can wait until after the election. I think we have to show to the marketplace and to the financial centers that we are ready to make the tough choices. And the idea that because we have stated that we are

going to do this or that based upon certain conditions and therefore we cannot change the course or make a correction does not make sense to me. And I cannot see how it can make sense to you as a businessman.

Time and time again in your business enterprises you certainly saw conditions change, and you changed the means of achieving your objective, and so I think the administration should. And I would like for you to comment on that.

Secretary REGAN. Well, first of all, Senator, I think that you would agree with me that if you look at the years 1981, 1982, and 1983, the average taxpayer still has yet to see a tax cut. In 1981 the tax cut for the individual was 5 percent starting on October 1. It was 10 percent starting July 1 of 1982. Those are the only cuts that have come about.

In the meantime we have had both inflationary bracket creep plus an increase in social security taxes. So if you weigh the two, people are now just about even—not much of an increase in taxes, but no real decrease yet.

This is the first tax decrease that most individuals will have. We think that a tax decrease will be very stimulative to the economy, and the economy certainly needs stimulation at this time.

The Fed is also remaining accommodating to this. Monetary policy has been eased since last July, and the Fed has said in its open testimony that it will remain accommodative in this posture.

We agree with you that these near-term deficits should be cut. We think that the economy can stand them in 1983 and 1984, but not forever. As the economy recovers in 1985, 1986, 1987, and 1988, it certainly will be necessary to adjust both fiscal and monetary policy to meet the new conditions.

Senator BENTSEN. Mr. Secretary, I think your candor was impressive when you said we should wait until after the election, but by the same token, I do not think it is the right decision for the country, and to try to get these long-term rates down.

Now, let me comment because I see my time is running out. You made a side comment about the reserve to loan losses for banks. I think it is incredible to cut the reserve for loan losses for banks with the Penn Square and the Continental Illinois in the depths of the recession, because I have seen more nonperforming loans than I have seen in financial institutions in a long time. I get deeply concerned about the financial structure of the country.

Secretary REGAN. Well, Senator, notice I did not suggest it. The chairman asked me a question about taxation of banks, and I said that those were two areas that this committee had looked at previously.

Senator BENTSEN. Thank you very much.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Secretary, there was an article recently in the Washington Post and other analyses by the group that showed that the administration's freeze on spending is actually not a freeze but an actual reduction in domestic programs; that is, if you take the total recommended increases for the next fiscal year, including the defense increase and other increases for medicare, social security, et cetera,

the net reduction is about a $10.1 billion reduction before inflation in other programs.

And I was wondering whether you had a chance to look at those analyses and tell us whether you agree with those analyses that the freeze is actually a reduction in those domestic programs?

Secretary REGAN. In those particular programs, yes. It varies with the program. There are some programs besides defense, however, that have been increased. Some of them in the social welfare area—for example, Head Start, and the college work-study program, things of that nature—have been increased in the budget.

What we have attempted to do in the budget is to have the overall level of Federal spending stay even with inflation. No real increase in the overall domestic spending. That means that spending on some will be up, some will be down, within the overall budget itself.

Senator BAUCUS. So that with the $30.5 billion increase in defense and $9.5 increase in social security, $6.8 increase in medicare, and the $14 billion in interest on the debt added into that, the $8 billion reduction, I believe, is in unemployment compensation benefits. That nets out at a $10 billion reduction in other programs.

Secretary REGAN. In general, yes, I would agree with you on those figures. I have not checked them precisely.

Senator BAUCUS. So it is not a freeze on all of the domestic programs. Rather, it is a reduction of approximately 4 percent before inflation.

Secretary REGAN. In certain parts of the budget, yes.

Senator BAUCUS. Meanwhile, the point I want to make is not only that point that actually the program is a reduction in domestic programs, but also, as I understand it, the alleged $55 billion reduction in defense spending over the next 5 or 7 years—I have forgotten which—is actually taken as a base mark, a benchmark of the President's defense spending budget a year or two ago, and rather not the last year's defense level spending as a benchmark that the President agreed to.

Secretary REGAN. It is down from the Presidential recommendation of February 1982.

Senator BAUCUS. So, in effect, it is a $55 billion reduction from that earlier benchmark which the President later agreed is too high. So that in fact it is not a $55 billion reduction from the last year's agreement; it is $55 billion from a previous year.

Secretary REGAN. $55 billion from the previous recommendation.

Senator BAUCUS. And the recommendation, as you know, is not accepted.

Secretary REGAN. That is right. Nor was most of the budget last year.

Senator BAUCUS. The main point I want to make, though, is that following on Senator Bentsen's point, it frankly seems to me that the recovery, when and if it ever occurs, is more likely to occur the more the administration and the Congress makes those tough choices that we all know we have to make; that is, postponing a tax increase or revenue increase to future years on some contingency rather than this year, 1983 and 1984; making defense spending adjustments—that is, cuts that we should make and other cuts we should make—and perhaps some revenue that we really need I

think is going to, in my personal view, send the right signal to the country, the financial markets, that we are going to do much better; therefore, the recovery is going to occur.

I am just curious why the administration is not going to further in reducing the deficit. The projected deficit in this fiscal year is going to be almost $200 billion. An outlook through 1988 is for deficits of upward over $100 billion. It looks like the administration has abandoned its commitment to a balanced budget, to reduce deficits in a very significant degree, even with the so-called contingency tax that would go into effect in future years.

Why is not the administration doing more to reduce those deficits?

Secretary REGAN. When you look at where we could go in order to cut deficits, there are very few places left. We drew up a list of about $16 billion of certain things that we recommended be cut last year. We were told in no uncertain terms by Congress there was no way they were going to cut those things. These included things such as handicapped education, $1 billion; disadvantaged education, $3 billion; higher education, $3.6 billion; impact aid, half a billion; women, children, and infants, $1.1 billion; employment and training, $2.4 billion.

There is no way that the Congress would allow us to cut those programs.

Senator BAUCUS. What about the other item which the Congress is going to cut and that is defense?

Secretary REGAN. Well, I am a member of this administration, and I support the position of the Commander-in-Chief and the recommendations of the Secretary of Defense and the Joint Chiefs.

Senator BAUCUS. What about the comments of many CEO's of large defense contractors that they cannot absorb those kinds of increases; they cannot handle them?

Secretary REGAN. Well, since I would not want the Secretary of Defense telling me about the tax field, I do not think I should get into his field, Senator. I simply do not know enough about the defense contracts to comment on that.

Senator BAUCUS. I think you know that this Congress is probably going to trim those defense figures.

Secretary REGAN. I have heard that for the last few days. [Laughter.]

Senator BAUCUS. And I just feel, therefore, that the administration ought to work with the Congress in reducing those defense increases and work with the Congress in areas in which the Congress inevitably is going to go and this whole town knows we are going to do, rather than fighting us tooth and nail down the line; because the more we do have that kind of bipartisan agreement again, the more we are likely to go down the road of recovery that we want to go on.

Secretary REGAN. I understand, Senator.

Senator BAUCUS. Thank you.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Secretary, over the last week or so I have listened with great interest to various presentations by the President and by you with respect to the administration's economic program, and I would just like to give you some comments for

whatever they are worth, and then maybe you would like to react to them.

It is certainly true that a recovery would reduce the size of the deficit. I believe it is also true that projected very large deficits are the greatest cloud on the horizon with respect to economic recovery. And therefore, it seems to me that if we are going to have a recovery, the horse has to come before the cart, and we are going to have to reduce that deficit and reduce it very substantially.

I think that it was absolutely right for the President to appeal to bipartisan cooperation as he did in his state of the Union speech, but it seems to me that if we are to get bipartisan cooperation, there has to be some give on the part of the administration as well as some give on the part of the Democrats in the Congress. And I think that they are willing to be forthcoming with respect to spending programs, and particularly with respect to the entitlements. But the administration in turn is going to have to show a little more flexibility than it has with respect to revenues and with respect to the military.

On the question of revenues, which is the matter before this committee and the matter with which you deal, it seems to me that there are two big areas here. One is the third year of the tax cut, and the other is indexing.

Now, with respect to indexing, I voted for it. I voted for the 3-year tax cut. But the administration never asked for indexing. It was not even added by this committee. It was added on the floor of the Senate. And philosophically I think it makes sense. I understand the philosophy behind it. If we are going to have tax increases, they should be legislated tax increases. But if our objective is to reduce the size of the deficit in order to foster economic recovery, it would seem to me that indexing would be one area where there would be a fair amount of ease on the part of the administration in being able to make some concessions, either by abandoning or putting it off or somehow adjusting the formula for the indexing, modifying it in one way or another. And that that perhaps would make a lot more sense than the so-called standby tax.

And on the third year, I would like to keep a third year of the tax, but if we are putting off for 6 months or a year various adjustments in cost-of-living benefits under various Federal programs, it seems to me that we could put off for a year the third year of the tax cut, or we could have some kind of cap on who it goes to.

But I believe that it is absolutely essential to reduce the size of the deficit. Here we were, the administration and the Congress, as recently as last year advocating and in the Senate many of us supporting a balanced budget amendment to the Constitution, and it just seems as though that was a fiction when we are now projecting deficits of about $190 to $200 billion a year.

So my views, for whatever it is worth, are that I think that the administration should show some flexibility and should be forthcoming with respect to both revenues and military. I think that it can do so consistent with the general objectives of the administration, and I believe that the result of that would be very positive response on the part of the financial community.

Secretary REGAN. Thank you for those observations, Senator. Let me comment a little bit about it.

I think let us talk about the third year first. That is the most immediate item on the horizon. In addition to the answers that I gave previously about why we should keep the third year cut, I think you must also keep in mind its effect on small businesses. As you know, 85 to 86 percent of all small businessmen pay individual income taxes. If you eliminate the 10-percent tax cut that is coming up July 1, in effect you are raising taxes on small business.

Small businesses, as we all know, are one of the major providers of new jobs in this country, and certainly trying to get unemployment down is something that we all agree has to have priority. So I would think that in thinking through to the effects of restricting the size of the third-year cut, you could not get at this through use of a cap. How to construct it would be a nightmare in terms of its administration.

Mr. Chairman, I will come back to indexing in response perhaps to another question.

The CHAIRMAN. Go ahead.

Secretary REGAN. Well, as far as indexing is concerned, we think that the case has been made that with inflation in this country, taxpayers have a right to expect the Congress to enact tax laws rather than to receive a dividend from inflation that could be caused by any number of things. It could be caused by the Federal Reserve and money supply. It could be caused by OPEC price increases.

I would not want to see our tax code surrendered to inflation by this Congress. I think that you had the right philosophy when you passed that last year. I think you should keep it in place to ward off any attempts to try to get at the so-called inflationary dividend by either bad fiscal or monetary policy by or exogenous acts.

The CHAIRMAN. Senator Mitchell.

Senator MITCHELL. Thank you, Mr. Chairman.

Mr. Secretary, we are hopeful and encouraged by some of your optimistic remarks. I must say, though, in all candor that we have heard that song before. For almost every month in the past 2 years you have made similar statements. Unless the world goes into a depression, then sooner or later you are going to be right. And we all hope you are this time. We all hope and pray, and so do the American people.

But I must say that I do not think there is any more basis for real optimism now than there was when you made similar statements in January, March, July, November 1981, February, April, May, and October 1982.

I want to make a comment about a statement you made in response to Senator Bentsen's question in which you said the average taxpayer has yet to see a tax cut. And of course you are right, but implicit in that is that the higher income taxpayer has seen a tax cut, has he not, and the higher one goes, generally the higher the cut that he has already seen.

Secretary REGAN. Yes, particularly since the 70-percent tax marginal tax rate has been reduced to 50 percent.

Senator MITCHELL. And what is happening is that as a result of the tax policies that you have proposed and encouraged, there is underway a massive shift in the burden of taxation in our society away from those at the upper end of the income scale and on to

primarily the backs of the middle class, because the reductions you have proposed have been in the areas of income that are related to income, and the increases have been in the areas unrelated to ability to pay.

I was intrigued by your statement that it would be a mistake to raise taxes in 1983 and 1984 because of the recession, and here you sat here in 1982 in the depths of the recession and proposed a massive tax increase, not one aspect of which was related to ability to pay, all of which was unrelated to ability to pay; and therefore when combined with reductions in taxes that are based on ability to pay, produce this massive and ongoing shift in the burden of taxation in our society. I think that is a very disturbing trend as a consequence of those policies.

And I just also would like to say you have in your statement—you said over the past 2 years we have seen evidence that the administration's program is working. Inflation has been brought under control. Indeed it has, and for that you and the President and the administration deserve credit. But at the same time the same policy has produced massive unemployment, and for that you deserve some of the responsibility.

And I think what is distressing to me and many people is the constant effort represented by this statement here made over and over again by the President and his spokesmen that our policies have reduced inflation, and therefore we deserve credit; but we do not have anything to do with the rise in unemployment.

We all know that the relationship between unemployment and inflation is an intimate one and that the same policies that have produced a reduction in inflation have produced the increase in unemployment. And I do not see how you can sit there over and over again and just keep saying have we not done a great job bringing down inflation, but unemployment is the fault of those other guys. You deserve credit for one, and you deserve responsibility for the other.

And I hope that if we want bipartisanship and if we want realism, we start to acknowledge that you cannot take credit for all the good things that happen as a result of your policy and avoid any responsibility whatsoever for anything bad that happens as a result of the very same policies.

Secretary REGAN. Well, Senator, I will try to remark on some of your observations.

First of all, I admit that I was wrong in 1981 and 1982, but so was the CBO. So were all other forecasters. There are very few forecasters who can say they were correct in 1981 and 1982, so I am no better or worse than everyone else in this business.

As a matter of fact, Mr. Chairman, that reminds me of something that I think I would like you to work on with the Budget Committee. Perhaps the two of you can get us out of the requirement of having to forecast for 5 years. I do not know who believes 5-year forecasts; I certainly do not. This year we have simply extrapolated a straight line out for 5 years because none of us knows what is going to happen. Yet we are required by law to do this.

Now, as far as some of your other remarks, last year's tax increase—as you call it, a massive tax increase—the emphasis, as I recall, was mainly in the areas of tax compliance and loophole clos-

ing. I would not characterize these as a tax increase in the middle of the recession.

We also were trying to get at the budget deficits last year. We had an "unstated" understanding with the Congress that there would be $3 of deficit-reducing outlay measures for every $1 of tax increase. That bargain was not upheld. We got the tax increases. We did not get the outlay reductions. We were trying to do then what we are still trying to do. We must reduce deficits in order to get interest rates down. If we do not get interest rates down, we are not going to have a recovery. We are basing our hopes of recovery on the fact that we think interest rates will come down if fiscal responsibility is observed both by the administration and by the Congress.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Mr. Secretary, what bothers me is that constantly through this testimony runs the concern of the high interest rates which we all acknowledge. I think we all also make a direct correlation between high interest rates and the unemployment. If we can get the interest rates down, we can get the unemployment down. I think you have said that. The President has said that. We all agree on that. The problem is how do we get the interest rates down?

I think we also acknowledge there is a direct ratio between the deficit and the interest rates, and I have great trouble understanding why this administration presses ahead in in effect reducing its revenues which therefore increases the deficit; in these times why you persist in the third-year tax cut, whether it is across the board or whether you eliminate it merely for those in the upper brackets, and pressing ahead with this indexing. I cannot understand.

And would you please explain why the cut in revenues which would result from these programs are not going to continue to keep the deficit high in the $200 billion area and thus the interest rates high and thus the unemployment?

Secretary REGAN. Well, first of all, Senator, let us have an understanding that interest rates are not solely determined by fiscal actions. Monetary policy comes in here—which I will come to in a moment—but let us talk about the fiscal side of it.

What we are talking about here is literally how do we finance the deficits. We all admit we are going to have deficits. How do we finance them? We have two ways of doing it. One, we can tax and raise revenues that way, or two, we can borrow.

Now, at a time when we are in a recession——

Senator CHAFEE. Let me just interrupt. If you tax, it reduces your deficits, whereby if you borrow, it does not reduce them. There is a difference. One is reducing a deficit; the other is not. Is that not true?

Secretary REGAN. Right. But you have to think in terms of what the act will do to people. Do you kill incentives, do you take away people's savings, things of that nature, when you tax rather than borrow? Now, what we are saying is, that when you are just coming out of a recession, it is better to borrow than it is to tax, because you are allowing people to keep their own money. A dollar in the private sector turns over at a much faster rate and is much more productive than a Federal dollar.

Now, if you were to reduce it to the absurd, say that we will tax everything from everybody. Do you think that would cut Federal spending?

Senator CHAFEE. Well, let us take the other absurd. If you are going to play that way, I think you have got to to the other way to follow your theory through, have no taxes and borrow completely, and the country would really get moving.

Secretary REGAN. No, I am not saying that, because what would happen then, there would be no room for anyone else to borrow and there would be no money available for housing or for new plant and equipment or anything else. What we are saying is you have to strike a balance, and in our judgment the balance now should be to keep the tax cut and allow individuals to have money in order to regenerate the economy, rather than letting the Federal Government take that money away from them.

We are saying we can borrow, and we I think have demonstrated that. Since last July we have had the most massive borrowings in the history of the United States, yet interest rates have come down. We think the same thing can happen in 1983.

But what I suggested in answer to another question is that we cannot afford to keep doing that in times of prosperity, which we believe will be the future years, 1986, 1987, and 1988, or 1985, 1986, 1987, and 1988. In those future years, there is no way that you could keep up massive borrowings. You would overheat the economy.

Senator CHAFEE. I would like to return—by yielding on that question I am not saying I am convinced, but let me get to the next one.

It seems to me in the thrust of these programs there has to be a sense of equity portrayed to the public and to the Congress. Last year we passed taxes that were disproportionately heavy on the lower income, the gasoline tax, the social security tax, the cigarette tax. We are now proposing another change that is disproportionately heavy on middle or lower income, namely taxing fringe benefits, medical fringe benefits about $175 a month.

Now, plus we are seeking cuts in the entitlement programs, that is, cuts in spending which obviously disproportionately hit the lower class. We had a tax cut that gave it to the rich, namely from the 70 to 50 percent-plus, with its effect on capital gains reductions.

Now, where is the equity in persisting with this complete across-the-board third-year tax cut? How are the rich nicked under your program?

Secretary REGAN. Everyone is going to get a 10-percent reduction in his tax bill. We think that is fair.

Senator CHAFEE. But that will bring the lower income people about up to where they were before the cigarette, the gasoline, the social security, the fringe benefit taxation, went into effect, is that not right?

Secretary REGAN. Yes.

Senator CHAFEE. And so the people who really make out under it are the upper income people.

Secretary REGAN. Well, let me point out that 72 percent of that tax cut starting on July 1, 1983, goes to those with $50,000 or less in adjusted gross income.

Now, as far as the health cap is concerned, since this is the first time that has been brought up, let us talk about that for a moment. That proposal affects only 18 percent of all workers. Those plans are companywide, the president of the corporation who earns well into six figures as well as the worker. They all get the same health benefit program.

What we are saying is, is that if you receive employer-paid premium that exceed $175 per month, the portion above $175 will be taxable to the employee. We think that that is eminently fair. If you look at the majority, 72 percent of all health plans in the country have premiums below that level.

Now, some plans provide benefits that are unusually high. These are the only employees that would be affected. Take two workers each getting $20,000. One gets a plan that gives him $2,500 or $3,000 in untaxed benefits, the other worker does not get that. If he were to get the same amount in a dollar raise from his employer, it would be taxable.

So we are trying to affect equity among workers with this proposal. You are talking about equity. I think that what is being proposed is very fair.

Senator CHAFEE. Well, my time is up. I will get back to it. Mr. Chairman, thank you.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thanks, Mr. Chairman.

Mr. Secretary, I know that you are concerned about the Federal deficit. I know it is sometimes difficult to argue that concern because the deficit this year is so large and it looks terrible for next year and the year after. But I know you to be a man who is fiscally responsible, and I would assume you would agree with the proposition that the reason you are concerned about real deficits is that when you have them one of two things can happen, and they are both bad.

One of the things that can happen is somebody will come along and monetize the national debt, as happened during part of the 1970's, several times in the 1970's, as a matter of fact, and the consequence of that is that ultimately the people who save money realize that we are spending money when the national debt is monetized. The money you have got in a savings account ends up being worth less, for a variety of reasons that we do not need to go into.

The other possibility is that the Federal Reserve System responds to a high deficit and says, we are going to respond by clamping down, we do not want inflation, and as a result you get no investment because the return to investment has been wiped out by high interest rates.

So the two things you get, there are two very different effects from a high deficit and they are both bad. There is therefore no good that comes from high deficits, I think. Would you agree with that analysis so far?

Secretary REGAN. Yes, I would, Senator.

Senator HEINZ. Now, what troubles me about the administration's proposal is that with respect to your contingency tax, we only, under your plan, would have those revenue increases enacted if we did everything else in terms of cutting spending right. Now, certainly we would like to do everything right.

We would like to hold the line on spending right and we want to get the deficit down, and you yourself admit in your proposal we need to get the deficit down. That is why we have this contingency tax plan assuming we do everything right.

What is difficult to explain to my colleagues, to our constituents, is if it is a good idea to put in the contingency tax plan when spending is being held down in order to get the deficit down, how do you justify not having the tax plan in if things go bad and the deficit is worse?

Secretary REGAN. Well, first of all, if the deficits get worse, this contingency tax plan would be in place. We would hope that in those outyears—particularly as our projections indicate that that would be a time of prosperity—we would not be running a deficit equal to 5, 6, or 7 percent of GNP.

If we were to do that, we would cause the very things you said at the outset to happen; that is, that we would be right back into inflation with very high rates of interest and we would bring ourselves into a recession.

Senator HEINZ. Mr. Secretary, as I understand the plan, though, what the tax increases in 1986 are contingent upon is cutting spending to below certain levels. If we do not cut spending, for whatever reasons, to below those levels, we will not get the contingency tax put into effect.

Therefore, as I understand it if we do not cut spending we do not get the contingency tax and the deficit is worse off, is higher because of two things: First, we have not cut spending; and second, we do not have the additional receipts from the contingency tax, so we are facing not just a $100-plus billion deficit or whatever it would be in 1986, we are facing something twice that bad.

Now, the point of my question is this: We have got to set public policy and we are being asked to enact a kind of a dramatic step function proposal here where, if everything works out the way you want it it happens; if it does not work out the way you propose, catastrophe results.

Now, you know as a businessman that if we are really going to have lasting economic recovery, slow, steady, sure growth, that there has to be certainty built into our tax system, that there has to be certainty built into our economic system. How do you defend the fact that this really creates more uncertainties than certainties?

Secretary REGAN. Senator, I think that it removes some of the uncertainties. First, we would all think that the Congress would exercise fiscal responsibility and not let these deficits get out of hand. We are relying upon commonsense here, that the Congress in a time of prosperity would be cutting back on the scale of Federal spending because there would be literally no need for it.

Second, we would say that if people believe that Congress will raise taxes somehow or other in 1985 or 1986, they indeed will be very uncertain as to how that tax hike would fall. You would have every interest group saying, "not me, not me, not me." What we are trying to do is to make it as certain as possible where the tax hikes would fall, so that people could plan ahead.

Senator HEINZ. Mr. Chairman, I can understand the logic, and this is something I remember Alan Greenspan used to work very

hard to get us to think about. In 1974 and 1975 when he was President Ford's economic adviser, he used to say, the way you ought to propose, the way you ought to get the Congress to cut spending is that you will make a tax cut contingent on cutting spending.

Now, you are doing just the opposite and it is really hard to understand why the people of the United States are going to ask us to cut spending in order to get a tax increase on themselves.

Secretary REGAN. If you cut spending enough, there will be no need for this tax increase. Remember, we said if you cut spending to where it is less than 2.5 percent of gross national product the contingency tax would not go into effect. So all you have to do is to cut expenditures more.

Senator HEINZ. Maybe I do not understand your proposal, Mr. Secretary. Maybe I am operating under a false premise.

The CHAIRMAN. I think it would be necessary to understand it. [Laughter.]

Senator HEINZ. I thought the tax went into effect only if spending got cut.

Secretary REGAN. No, not only if. Only if the deficit is higher than 2.5 percent of gross national product.

Senator HEINZ. And that has no relation, of course, to whether or not we cut spending.

Secretary REGAN. Oh, it has a relationship certainly, and also to the growth of the economy.

Senator HEINZ. OK. Thank you, Mr. Secretary.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you, Mr. Chairman.

Mr. Secretary, am I correct in saying that if all the Federal income and excise tax increases proposed by the administration do go into effect that in the period 1982 to 1986 taxes will have been increased about $247 billion?

Secretary REGAN. You are talking about——

Senator BRADLEY. The 1982 tax increases plus the contingency tax increase.

Secretary REGAN. Let me check those figures, Senator. Just 1 second.

[Pause.]

Secretary REGAN. The tax increases, according to a table I have here in my hand, from 1982 on would be about half a billion to $550 million over the period 1982 to 1988, and that would be subtracted from the tax cut of $1,138 million.

Senator BRADLEY. $500 million?

Secretary REGAN. I meant, billion. That is, social security, gas tax, and last year's TEFRA.

Senator BRADLEY. All right. I just wanted to confirm the size of the tax increase that will be recommended.

Why did you change your position on quotas for the IMF at the Toronto summit? You said no increase in quotas and now you are recommending an increase.

Secretary REGAN. Bargaining, Senator. We went into that knowing very well, having heard from a lot of other nations at Helsinki in May, that they wanted a 200-percent increase in the quotas. The lowest that I heard was a 100-percent increase in the quotas.

I checked here on the Hill, even with ardent supporters of the IMF, and there was no way that 100 percent would even fit. So we low-balled it going in.

Senator BRADLEY. Why do we need to increase the quotas?

Secretary REGAN. That is an entirely different thing. The world's monetary situation today is in a very precarious situation. There are many nations that are on the verge of default; many are barely staying even with their interest payments, let alone their principal payments.

Senator BRADLEY. Why is that?

Secretary REGAN. Two things have happened. One, they borrowed heavily in order to try to accomplish certain social programs at home that they deemed necessary; and at the same time, in this worldwide recession commodity prices have fallen drastically, whether it is rubber or cocoa or coffee or what have you.

Senator BRADLEY. What about interest rates?

Secretary REGAN. Interest rates have also been enormously high in the same period.

Senator BRADLEY. Why would you say they are so high?

Secretary REGAN. Because of inflation, worldwide inflation, particularly inflation in the United States.

Senator BRADLEY. Why were interest rates the only way of fighting inflation?

Secretary REGAN. Well, you asked about inflation as far as interest payments were concerned. That is the cause of it. Also, of course, our own fiscal actions here, our huge deficits and the like.

Senator BRADLEY. And what caused the huge deficits?

Secretary REGAN. More spending than revenue.

Senator BRADLEY. Do you believe that the tax cut had no effect on the deficit?

Secretary REGAN. The tax cut's effect on deficits?

Senator BRADLEY. Yes, the tax cut, the defunding of the Federal Government in 1981.

Secretary REGAN. To the extent that when we proposed tax cuts we also proposed spending cuts, and to the extent that we did not get the spending cuts commensurate with the tax cuts, certainly that was a contributing factor. But you would have to say——

Senator BRADLEY. Are you before the committee today arguing that you recommended spending cuts equivalent to the tax reduction?

Secretary REGAN. No, not the equivalent, but last year we recommended more.

Senator BRADLEY. In total?

Secretary REGAN. In total.

Senator BRADLEY. If you take the defense increase together with what you recommended in spending reductions in nondefense, and then you take away the revenue source, the deficits were almost predestined. And the thing that troubles me is that virtually every finance minister in the industrial world knew that, and yet you persisted in passing the policy under the belief, as you continue to express today, that this little tax cut that is going to go into effect in July is going to produce gigantic growth.

The result is this recession, and you cannot take the numbers and justify your statement. The tax reduction of 1981 balanced

against the defense increase and the spending reductions that you recommended together with the tight money policy that this administration has followed from the outset guaranteed this recession. And to persist to deny this reality does not lend to the promotion of the bipartisan spirit that Senator Danforth said would be necessary to pull us all out of this problem.

Secretary REGAN. Well, let me take a look at that. In 1981 the tax cut was $400 million only, not even a billion.

Senator BRADLEY. Over a 5-year period——

Secretary REGAN. Wait a minute. If we are talking about the deficit in 1981 and 1982, Senator—that is what you were talking about.

Senator BRADLEY. We are worried about the deficits in 1985 and 1986. The point is, you have got to look at the deficits over time.

Secretary REGAN. No, Senator. You asked me about the deficits that caused these high rates of inflation. The deficits in 1986 and 1987 are deficits that are to come. What is causing these high rates of inflation in the short term are the deficits in the years 1981, 1982, and 1983.

In 1981 we had a tax increase after that $400 million. We then had bracket creep that added almost $10 billion and the social security tax hike added almost $4.5 billion more, for a net tax increase in 1981.

Now, in 1982 we had a decrease of $35.5 billion under the tax cut. Bracket creep took away 17.3 percent of that, and social security tax increases another $8 billion. So there was a net tax decrease in 1982 of $10 billion, and yet the deficit was $110 billion. So you could hardly say that the taxes added an enormous amount to that deficit.

This year, with a $208 billion deficit, net tax decreases, after the social security taxes, after bracket creep, and after TEFRA, the 1982 act, come out to $14 billion. So again, out of a $208 billion deficit, taxes account for $14 billion. So I do not think you can say that the tax cuts were primarily responsible for the deficit.

Senator BRADLEY. What was the net spending reduction in the period, including increases in defense spending?

Secretary REGAN. There were no decreases in spending in 1982 and 1983.

Senator BRADLEY. Even though we agreed to cut nondefense spending $130 billion?

Secretary REGAN. Not in 1 year.

Senator BRADLEY. Over a 3-year period.

Secretary REGAN. But 1 year is what I am focusing on. Defense increases were not that much in 1982 and 1983.

Senator BRADLEY. Then why, if we cut nondefense spending $130 billion, did we have these deficits?

Secretary REGAN. Our revenues in 1983 were the same as they were in 1981. Because of the recession we failed to gain the revenue and because inflation was brought down we failed to gain the revenues that we ordinarily would have gotten through inflation or through prosperous times.

Senator BRADLEY. Mr. Secretary, all I know, and I will conclude because I know my time is up: We passed the tax bill the 1st of August. By the time we came back from the August recess, and

every Senator in here knows, interest rates had skyrocketed because people had looked at what that meant for the deficit in the outyears. And we have been coping with the combination of the tax reduction and defense increases and tight money since then, and that is what we are coping with today.

Before we can get out of this we have got to recognize what was the cause of the problem, and you can assert the opposite, but unless you are prepared to look at the facts over a period of 2 to 3 years then I really do not see how we are going to get out of it.

Secretary REGAN. But long-term deficits do not cause short-term interest rates to increase. Long-term deficits affect long-term interest rates.

Senator BRADLEY. Do we want to continue this?

The CHAIRMAN. We will come back around.

Senator Boren.

Senator BOREN. Thank you, Mr. Chairman. I apologize, I was delayed in the Agriculture Committee.

Following on what Senator Bradley just asked, Mr. Secretary, do you really think we can run deficits as large as we are talking about without putting extreme upward pressure on the interest rates, whether we talk about short-term interest rates or whether we talk about the availability of long-term credit at stable interest rates? Just as important, can we run deficits this large and have stable as well as reasonable interest rates so that we can begin to get back to fixed rate financing again?

With our 84 changes in the prime rate over the last 2 years, it is obvious that this instability has impeded any recovery.

Secretary REGAN. Well, as you know, interest rates are a result of both monetary and fiscal policy. Both of them go into the blend that makes for an interest rate in an open market.

Now, from the point of view of fiscal policy that which we are discussing here, I would say that higher deficits really make monetary policy much more difficult. If we are going to have a loose fiscal policy, monetary policy naturally tightens against that. If, on the other hand, we have a tighter fiscal policy, that is lower deficits, it makes monetary ease more feasible.

So I would say that what we are pleading for here is that these deficits be brought under control. Where we think the magic number would be is somewhere around 2.5 percent of gross national product. If we can keep our deficits below that in the outyears, we think there is plenty of assurance that interest rates would come down.

Senator BOREN. Well, I will not rehash the argument that has been made before. It does seem to me that what you are really saying is, the more we can bring the deficit down the better, because then we will not have to restrain monetary policy so much and therefore choke off an economic recovery. There are obviously some other ways we could bring the deficit down more if we consider delaying the third year of the tax cut and moderating defense spending, in addition to adopting a spending freeze on other programs, for which I happen to have great sympathy.

I was confronted with a question and I would really like to know how you would answer it and how the administration would

answer it. I have advocated a spending freeze, but I have advocated also an across-the-board freeze.

In other words, if we are going to ask the pensioner on social security or civil service retirement or the lowest paid Federal employee to have no increase whatsoever for 1 year or for some other period of time, I also feel we should do the same for the upper income person in terms of tax breaks for 1 year, and I think we also have to moderate defense spending for 1 year.

I had a person get up in a meeting and say, "I am depending upon a very, very small pension, but I am willing to freeze my pension," this person said, "for a year as long as everybody else does, too." The question was very bluntly put to me. It was not put exactly in this kind of language.

It was put in layman's language, "Senator, are you going to ask me to freeze my $400 or $500 per month pension and at the same time are you and the Government going to go borrow $25 billion to give a $2,400 per year tax break to an upper income person?" In other words, a strong feeling was expressed that if some are going to sacrifice they want everybody else to be in the same boat with them.

Now, laying aside economics or other considerations, how, on the basis of fairness, do we answer that person? How do we get that person to become a supporter of restraining his or her own Government benefits without throwing the rest of this into the mix at the same time?

How do you answer the question of whether or not it is fair to hold that one person down and to ask them to live on $500 a month, while borrowing the money to give a $2,400 a year tax break to someone at the $100,000 income range? How do we answer that question?

Secretary REGAN. All right, let me try it, Senator. First of all, I might add, as far as Federal workers are concerned there will not be a complete freeze. As you know, most Federal workers get a step-up within grade. They run an average about 3 percent per year. That will still go on.

What we are talking about is the portion over and above that, the 4 percent or 5 percent or 6 percent which is voted by the Congress. The same thing happens in the military. Within-grade you can move up. Those steps are not being taken away by our proposal.

Senator BOREN. What about my pensioner?

Secretary REGAN. I am coming to the pensions.

From 1978 to date, Federal workers who have been on a pension have seen their pensions increase 50 percent. Inflation increased in the same time only 40 percent, so they had a real increase of 10 percent in their pensions. Workers, on the other hand, got an average increase of only 38 percent during the same time period, so real wages declined between 1978 and 1982.

Now, if you go to private industry, you will find that there are no COLA's, to speak of. A few pensions that are in heavily unionized companies or industries have COLA's, but the majority of private sector workers do not receive cost-of-living adjustments of their pensions. It is only the Federal Government pensioners who get them.

Now, these people have gotten COLA's that exceed the rate of inflation. They have more than kept equal with it. So we are saying a pause for 1 year will merely allow everybody else to catch up with them.

Senator BOREN. Well, is a pause for 1 year easier for a person solely dependent on a $500 social security check? Is that easier for them to manage, then, than it would be easier for the person at $100,000 a year to manage doing without $2,400 for 1 year? Can you make that case?

Secretary REGAN. Obviously not. But on the other hand, you have got to remember that this person has benefited more from the system at this point. He has gotten more than cost-of-living adjustments. And even after the 6-month pause, he will still be way ahead of inflation.

Senator BOREN. Thank you.

The CHAIRMAN. We are now ready for the second round. As I understand it, Mr. Secretary, this is your fourth appearance this year in what, 14 hours so far?

Secretary REGAN. That is only between yesterday and today, I mean yesterday and the day before, the 14 hours.

The CHAIRMAN. So I do not assume we have even laid a glove on you. [Laughter.]

Secretary REGAN. I am getting a little bit tired of dancing. [Laughter.]

The CHAIRMAN. You have been dancing for 2 years. [Laughter.]

Secretary REGAN. A little over that.

The CHAIRMAN. Well, we know that it is a very difficult job and we are looking for bipartisanship, but first we have to see the other plan. It is pretty hard to be bipartisan on just one plan. It is easy to stand and knock one plan if there is not another plan, and yet we understand there will probably be a comprehensive, unified Democratic proposal someday.

In fact, there will probably be several proposals. There will be the Glenn plan, the Hart plan, the Cranston plan, the Bumpers plan, and other plans, and that is going to make it more difficult.

But I think you have sensed some frustration by members of the committee. Do you detect that? [Laughter.]

Secretary REGAN. It is becoming a little bit obvious.

The CHAIRMAN. And I do not say it critically, because I know you have a very difficult job. Maybe we could just amend the Budget Act so we do not have to make those 5-year projections, and we would not have to worry about revenue projections. I am not certain they are very helpful, anyway.

But we are a responsible committee, and if we cannot accept some of the recommendations or if we cannot find a consensus, then we certainly have an obligation to offer something else, and we will try to do that. But there are a number of positive things that the President addressed in his state of the Union.

One is pension reform to make the laws fair to women. As I assume Treasury is working on that and will be sending us a proposal in the immediate future, is that correct?

Secretary REGAN. That is correct, Mr. Chairman.

The CHAIRMAN. And we look forward to working with you in that area.

Also, Senator Chafee has had hearings on high tech. I think there is some feeling that there is a bias against new high technology companies in the tax law, and while I missed that hearing I know Senator Chafee has an interest in that. We are trying to make certain that there is no bias, and that if there is a bias it should be addressed.

But there are certain provisions that may make it more attractive for established companies to finance expansion than some new company, and we will be submitting some questions in writing in those areas for Treasury to address.

Secretary REGAN. I am unaware of that, but we will be more than happy to be responsive to the Senator's questions.

The CHAIRMAN. And I will have some and Senator Chafee will have some.

I appreciate your strong defense of indexing. I think that is probably the best thing we did in the 1981 act, and I know when we look for easy ways to find additional revenues that that is a fairly obvious target. What is indexing in 1985, 1986, and 1987?

Secretary REGAN. It comes out—let us see. Not much in 1985, $6.2 billion; $17 billion in 1986; $30 billion in 1987; $44 billion in 1988.

The CHAIRMAN. And I know there are some who opposed indexing on the committee. It was not, as Senator Danforth pointed out, adopted by the committee. It was a committee amendment which was voted on on the floor.

But again, we will be addressing some of the options in the outyears if in fact the contingency tax fails to have the necessary support.

You are not suggesting any action on the revenue side for the balance of 1983 or 1984 except, as I understand it, in the social security tax area—acceleration of the social security tax, the credit to offset the 1984 tax for employees, and other revenue provisions in the social security package. There is also the cap on tax-free health insurance. Is is that all?

Secretary REGAN. Well, we will be reintroducing the three that I mentioned in my prepared remarks: CBI, the tax portion of CBI, the enterprise zones, and tuition tax credits.

The CHAIRMAN. But none as far as general revenue is concerned?

Secretary REGAN. No, we will not have a general revenue bill in 1983.

The CHAIRMAN. It seems to me that if in fact, as we are told by IRS, that there is still maybe $100 billion, or $120 billion in noncompliance, before we look at the third year or indexing or any contingency tax we ought to focus on that. And maybe it is just so difficult that we cannot achieve much revenue gain in those areas.

But that, plus base broadening, seems to me to be a couple of options that surely should be addressed before we look into tax increases of any kind. And there is some interest in an oil import fee. It is not total, but I know some have expressed interest in that, rather than just an excise tax.

Secretary REGAN. Well, Senator, as far as those are concerned, we will be doing our homework. We do not propose or feel that there will be much action in this committee on those items until after you clear the social security proposals. So that will give us

time to work on these things, so we will be prepared if you or your staff want to contact us regarding any of these items.

The CHAIRMAN. It is our hope—and we have hearings starting on the 15th of February—to have a social security bill on the President's desk before the so-called Easter work period.

Secretary REGAN. I think that if you can adhere to that timetable in the Congress, it will be very reassuring to the money markets. That would certainly show fiscal responsibility and be very reassuring to the markets.

The CHAIRMAN. I think we succeeded in that compromise to upset everyone who might be affected, so that would indicate it is a fair compromise. No one seems happy with it, but no one has a better plan, and I think that is the strength of the compromise. The more you look around for ways to try to find the numbers necessary to make the $168 billion in the short term and the $1.6 trillion in the long term, or 1.8 percent of payroll, the more you realize that the package is not so bad.

So we are going to move on that.

Senator Mitchell?

Senator MITCHELL. Well, Mr. Chairman, I would just like to comment. In your remarks to the Secretary, you sought to create the impression that Democrats have not offered any alternative to the proposals that have been suggested here, and I, with all due respect, submit to you that that is not the case; that in fact Democrats on this committee and in the Senate have repeatedly made a number of proposals that have been rejected by the administration.

I would like to identify just four of them which I believe if adopted would be a much more fair method dealing with the problems that we now face: First, defer the third year of the tax cut, proposed over and over again.

Senator CHAFEE. For everybody?

Senator MITCHELL. Yes. Defer the third year of the tax cut.

Second, change the composition of the first 2 years of the tax cut to give a much greater portion of the reduction to those persons in our society making less than $50,000 and a much smaller portion of the reduction to those making more than $50,000 a year, a proposal which has been before this committee on several occasions and defeated by an overwhelming vote by the majority and in the Senate.

Third, repeal indexing—a more direct, more sure, more fair method of reducing future deficits than the so-called contingency plan. If anybody talks about gimmicks, to call repealing indexing a gimmick and to come up with this plan, I would say that is really a case of misstating the situation.

And fourth and finally, reduce substantially the proposed increase in defense spending, which simply cannot be justified by any rational analysis of this Nation's security needs.

That is a specific four-point plan, each of which has been proposed repeatedly by the minority in the Senate and each of which has been rejected in whole or in part by the administration and the majority. I do not think anybody should be under the impression that we have been simply critical without offering any alternative. I believe we have.

The CHAIRMAN. I did not mean it that way. I mean, I know there have been those general proposals, but I am talking about a com-

prehensive budget plan, which includes some spending restraint. The plan you have described has no spending restraint, except for defense. There is a lot of revenue.

I mean, medicare is $55 billion this year. We ought to be able to take a bite out of that, a big one. And it is headed for $110 billion by 1990 if we do not do anything. Ten years ago the 1990 forecast was $9 billion.

So I do not mean to suggest there are not a lot of ideas on the other side. There just is not that comprehensive package to shoot at or, I mean, to address.

Senator MITCHELL. Well, why do we not call this the Mitchell comprehensive package, and I submit it right now, Mr. Chairman, if you want an alternative.

The CHAIRMAN. Do you want a vote on it? [Laughter.]

Senator MITCHELL. We have already voted on this several times and it has gone down. I would like to have a vote on it.

The CHAIRMAN. I have got some proxies. [Laughter.]

Senator MITCHELL. And I recognize the vote would be the same, but that does not make it any less of a specific proposal.

Now, I would like to make one more comment on remarks made earlier. In the opening colloquy with the chairman regarding the payment of taxes by banks and in response to the chairman's questions, you said that you studied this last year and you certainly created the impression that as a result of certain practices by banks, and you referred specifically to reserves and tax-exempt bonds, that you created the impression that they are paying less than their fair share of taxes, and suggested that, with the chairman, that if the banks persist in urging repeal of the withholding provision, that somehow we are going to do something about this.

Well, all I want to say to you is, you are Secretary of the Treasury. You are charged with the responsibility of having the most fair and complete tax system possible, and if you felt last year and if you feel now that the banks are not paying their fair share of taxes, if they are engaging in practices which permit them to do that, then you have a responsibility to propose something about that now, or you had a responsibility last year, and not just use it as a threat against the banks that if they do not support the legislation which you supported or if they do not desist in their efforts repealing the tax, that then and only then will you do something about it.

You have an obligation, a moral and legal responsibility to do something about it if you think something is wrong, and I urge you that if you feel that is the case, come forward with a proposal, point out where the tax is not being paid, point out the inequities and the unfairness. But do not just say, if they do not back off on withholding then we are going to come up with something to get back at them.

I do not think that is the appropriate way to handle it.

Secretary REGAN. Well, you notice, I have not said that. I said that this was studied last year. We could study it between now and July 1 of this year.

Senator MITCHELL. There is no question, Mr. Secretary, that you sought to create the impression, unmistakably, that you want the banks to back off from their effort to repeal the withholding provi-

sion, and in an effort to induce them to do that you made it clear that if they do not back off you are going to try to do something about their taxes, which you imply are now unfairly low.

And all I am saying is that if they are in fact unfairly low you ought to—you should have done something about it when you first discovered it, not only in retaliation for their exercising their rights.

Secretary REGAN. Well, there is no doubt I have told the banks and I have tried to work with the banks on this withholding to find out the real reasons behind why they think it is going to be so burdensome. We have asked them to come forth with figures to demonstrate how this is going to be so expensive to them. They have yet to come forth with that.

We were very careful in working with this committee last year to so make the laws easy to comply with, and make it easy for people to have exemptions—for example, the elderly or those with small amounts of interest and dividends. So I think we have crafted the thing as well as we can, and we have had many meetings at IRS and the Treasury, open meetings for anyone to appear, in order to bring this forth.

Senator MITCHELL. Let me just make it clear. I am not commenting on the validity or invalidity of the legislation regarding withholding or of whether or not it should be repealed. I am not commenting on that and I am not asking you to comment.

All I am commenting on is what is in my judgment the inappropriateness of the Secretary of the Treasury of the United States seeking to deter people from exercising their constitutional right to petition their legislatures, by threatening to change the tax structure as it affects them and implying that they are paying an unfairly low share now.

What I am saying is, if they are in fact paying an unfairly low share, you should not be waiting until July 1 or any other time or relating it to the withholding fight. If banks are now paying a fair share and you as Secretary of Treasury conclude that, that has no relationship to what they do with respect to withholding. You have some obligation to come forward with a plan to redress that, to see that everybody pays their fair share, is what I am saying.

Secretary REGAN. We will be glad to study the matter and report back to you.

The CHAIRMAN. We do not want to be misunderstood, but we tried last year to bring banks into the minimum tax and I think the Senator from Maine voted against it. We are going to continue to pursue these areas, and not just because of their efforts on withholding.

They certainly have the right to petition if they do it properly, and I think most banks have. But there is a little deception going on out there about how this is a new tax and we are taking money away from older people. We have had a lot of mail from senior citizens who are not even affected by the provision, who have been frightened by what they read or heard from certain banks.

I do not want to declare war on banks, but I think it is fair to say that we are looking for ways to broaden the base of the tax system, and credit unions and banks, I think, should be scrutinized

as closely as we scrutinize others. And we intend to do that whatever happens on the other matters.

Senator Chafee?

Senator CHAFEE. Thank you, Mr. Chairman.

I would just like to welcome the Senator from Maine's support on this anti-indexing proposal. As he might recall, I was as vehement as anyone against that indexing last year or 2 years ago, in 1981. And we had one or two other votes on this side, but it flew through.

So it was not a Republican proposal, it was not a Democratic resistance that was overwhelmed by Republicans. It received votes on both sides, that is, support for indexing.

I have not had any occasion to change my views on it and welcome every ally we can find to resist this.

Mr. Secretary, it would be helpful to me if you could tell me whether the material we are getting from these banks through their depositors is accurate. As I understand, last summer the Treasury Department indicated that the compliance on interest and dividends was about 85 percent, 15 percent noncompliance.

The data that the financial institutions are circulating is there is a 97-percent compliance, based upon where they have tied up, the Treasury has tied up, the 1099's, matched the 1099's with the returns. Is that true? Is there 97-percent compliance?

I mean, it helps us. I am not saying it is or it is not. I do not know.

Secretary REGAN. Not according to our evidence at Treasury, Senator. Tax compliance is 85 percent, as we said last year.

Senator CHAFEE. So there has been no change from that.

Now, second, Mr. Secretary, I think you know that this year it is going to take a tremendous amount of time and a tremendous amount of good will and good temper for this committee and this Congress to proceed in a bipartisan way to achieve the goals that you are seeking with this program, however we might alternate it. And I find it extremely difficult to understand why you throw into this cauldron tuition tax credits, which is a divisive issue, which in my judgment is extremely unwise. I think it is devastating to our public schools and I just do not understand why you throw that ingredient into the pot.

Secretary REGAN. Well, the President of the United States promised this. He reiterated this last year. He again in Chicago earlier this year, again stated that he is for tuition tax credits. He would like to see a tuition tax credit. He thinks it is a fair type of credit, and that is the reason we have introduced it.

Senator CHAFEE. Well, we will obviously have time to review that. But just as one Senator, I wanted to mention that we have got enough divisive issues up on this Hill that consumed inordinate amounts of our time last year, as you know, and the year before. And to start down this track seems to me unwise.

And my final question is, in connection with the contingency tax, you propose a tax on, what is it, $5 a barrel on oil, imported and domestic. Why is that? Why do you not spread it to everybody, all energy? This inordinately hits those sections of the country that rely on oil for home heating and for industrial purposes, and this is a direct burden for those sections of the country. And if you want

your revenue, do it on a broader basis with a lower tax on all forms of energy, gas or hydro or nuclear, whatever it might be, and oil.

Secretary REGAN. Well Senator, we were looking, for something that would have a wide base, the type of tax that would be paid by many people, not just a specific section. Most people do use gasoline. Most sections of the country do have oil. Most of the utilities of the areas use them, and the like.

Senator CHAFEE. Mr. Secretary, you know there is wide disparity. Gasoline obviously is broad-based, but I mean, as far as home heating or industrial use or utility use.

Secretary REGAN. Well, again, we were looking ahead to the years 1986, 1987, and 1988, not just to the spring of 1983 or the winter of 1982-83, thinking ahead then that perhaps gas prices, oil prices, might be down more than they are now, that there would be more supply at that point, with some of these new fields that are coming in, both in the Arctic and off the coast of California.

So it seemed to us that oil prices would be down sufficiently to where this additional tax would not be that burdensome, and as a matter of fact our estimates are that people would be paying less in those future years, even with this tax, than they currently pay.

Senator CHAFEE. Oh, yes. But presumably the same follows as far as gas or hydro or whatever it might be. To me it is a regionally unfair tax that you have proposed.

Secretary REGAN. Well, we are afraid of natural gas, because prices there seem to be rising and it looks like they will continue to rise into the indefinite future.

Senator CHAFEE. Well, the oil has already had the walloping rise which is unmatched by gas, even starting with a common base in 1972 or whatever it might be. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

The CHAIRMAN. I just wanted to insert in the record information taken from the hearing we had in 1979 in May and June on effective tax rates on worldwide income of different corporations. Leading the list was petroleum and natural gas at 59 percent effective rate; manufacturing was 41 percent; electric, gas and sanitary services, 35 percent; real estate, 28 percent; coal mining, 26. At the bottom of the list was banking, 19.4 percent. And I will just put that table in the record.

It may have changed. I assume they have a lower rate now, but the record will reflect that we do need to do some work in that area.

[The material referred to follows:]

Table 2.- Effective Tax Rates on Worldwide Income, All Corporations With Income, and Corporations With Under $1,000,000 of Assets, by Industry: 1972

Industry	All Corporations		Corporations with under $1,000,000 of Assets	
	Industry rank	Effective tax rate	Effective tax rate	Corporations included
		Percent		
Petroleum and natural gas	1	59.4	23.8	85.1
Manufacturing, not elsewhere classified	2	41.9	32.3	86.2
Wholesale and retail trade	3	38.8	32.0	94.9
Credit dealers, brokers, insurance agents	4	38.1	29.1	95.1
Paper and allied products	5	37.4	32.4	79.5
Communications	6	35.7	27.6	79.6
Electric, gas, and sanitary services	7	35.4	28.0	89.8
Lumber and wood products (nonfurniture)	8	34.2	32.2	87.5
Contract construction	9	33.7	28.4	95.2
Primary metals: ferrous	10	33.1	33.2	75.7
Primary metals: nonferrous	11	32.4	25.4	72.4
Services	12	31.6	26.5	97.5
Transportation	13	30.3	26.6	94.3
Real estate	14	28.9	26.2	94.7
Agriculture, forestry, and fisheries	15	28.0	23.6	94.4
Unclassifiable businesses	16	27.0	25.4	98.8
Coal Mining	17	26.7	24.7	84.3
Mining, not elsewhere classified	18	26.2	22.4	76.8
Banking	19	19.4	26.8	6.7

Office of the Secretary of the Treasury
Office of Tax Analysis

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Mr. Chairman, let me just, if I could, follow onto what you just said. I think that this will be a session of the Congress in which the banking industry as such will be a real focus for a number of reasons, many of which are positive, namely the quota increase that will be required. And I really think that it will not be helpful for that battle if the preliminary battle on withholding has to be fought, and I would tend to agree with the chairman that if we could let matters that are concluded actually be concluded, that we would probably all be better off.

Let me ask you, on your tuition tax credit proposal, is it refundable?

Secretary REGAN. We have not come up with a specific bill as yet, so I cannot answer that yet.

Senator BRADLEY. Well, let me remind you, Mr. Secretary, that when this committee did report out a tuition tax credit bill last year that we cut it off at $50,000 and we did make it refundable.

Secretary REGAN. We fully intend the tax credit to be phased out for those with incomes between $40,000 and $60,000—not just at $50,000.

Senator BRADLEY. The committee actually phased it out at $50,000, but the more important matter is we did provide refundability. And I am sure that the administration does not want to deny the tuition tax credit to the parents of poorer students of parochial schools. So I would hope that you would see it as the committee did last year, that it would be wise to make it refundable.

When will you make this decision?

Secretary REGAN. Again, most of this legislation will be coming up after social security.

Senator BRADLEY. So the legislation will not be submitted until at least May or June?

Secretary REGAN. Well, probably April if we stay with the committee's schedule to have it reported by the April recess.

Senator BRADLEY. One other question I have is, the President in his state of the Union message and you on various occasions in the last month or so have stated your support for a tax system that people can understand. What will the Treasury be doing in this area in the next several months and what can we expect in the way of recommendations or maybe even specific proposals?

Secretary REGAN. What we will be doing is studying it. As a matter of fact, you know better than I that this committee has had many hearings on this. We want to go over all of that to see what ideas there are and take a look at several of the proposals that have been made and sort these out to see which ones, if any, the administration feels it should support.

Senator BRADLEY. Do you agree with the President's statement in Boston several weeks ago that we do not need a corporate income tax?

Secretary REGAN. Well, I think the President there was philosophizing. As you know, there are many proposals to integrate the corporate and individual income taxes. But, I think the President was just philosophizing more than suggesting tax legislation.

Senator BRADLEY. So he was not making this statement with the benefit of a Treasury study?

Secretary REGAN. No, although we will study it.

The CHAIRMAN. We do not plan any hearings on it. [Laughter.]

Senator BRADLEY. On your contingency tax, I think the point that Senator Heinz was making was a good point, and that is if you are going to make it contingent on something do not make it contingent on the deficit, meaning that the higher the deficit is the more likely you are going to have a tax.

I would suggest you make it contingent on the unemployment rate, because you could very easily get yourself into a deflationary circumstance where you have locked yourself into a tax increase if the deficit is sizeable, when that is precisely the time you do not want to increase the deficit.

And then if I could, one final comment. I think our exchange earlier is really to the point, that if you are going to really need bipartisan support this year—and I do not know if you have made that judgment this year or not, but based upon what I heard on the other side today I think you might—I think that it would really be helpful for you to at least admit that if you have deficits, that if you argue that only spending causes the deficit, it is a little bit like arguing that only one blade of the scissors cuts the paper.

I mean, spending and tax cuts are two blades of the scissors, and if you do not say that they are both responsible I think that you will not only be receiving very little help over here, but you will be kind of held to the reality principle and in that sense not be viewed as credible.

All I think we want is some candor on these issues, that the time of the supply-side miracle is really over and that the admission that that is so, that it is not a surprise to anyone. I mean, virtually anyone you talk to, whether it is members on the other side, on this committee, or the Business Roundtable or Wall Street or the Germans or the Japanese, all recognize that not only was that a mistake, but it was clearly not possible.

So let us just put that behind us. We have 2 years to go to try to bring the economy back, and let us work together. And that is my own plea to you.

Secretary REGAN. I think if I might just make two quick comments on that, Mr. Chairman. First of all, I think you should consider a third factor in considering the deficits of the past several years, and that is the recession. I think a lot of that deficit was caused by the recession.

The other comment, Senator, is that I hope you do not feel that I am being too partisan if I try to rebut some of your remarks. I am merely trying to uphold the point of view that I have. Most certainly will try to operate in a bipartisan mode. But when I do have a philosophy, I think I should express it.

Senator BRADLEY. Well, I agree with that, and as long as you do not try to rebut those views in New Jersey I certainly will not think you are being partisan. [Laughter.]

The CHAIRMAN. Let me say, I know you need to leave here in a minute or two, but we are planning, hope to have some—as Senator Bradley knows—to have some field hearings on flat rate tax and other proposals. And I am certain we will have the cooperation of Treasury. We may need information, but it will be some time

later this year. If we have a little recess period, we may have a hearing in New Jersey or Kansas or somewhere.

I think Senator Mitchell wanted to clarify something, and then I will yield to Senator Boren.

Senator MITCHELL. Yes; just one point in response to your question from Senator Chafee regarding the 85-percent compliance. Is it correct that the 85-percent figure is the average of compliance with respect to all interest and dividend income?

And second, is it not correct that within those totals there are varying rates of compliance with respect to interest and dividends and different forms of interest? And finally, is it not correct or is it, I am asking you, that there is a much higher rate of compliance with respect to interest earned on savings accounts than there is interest earned on debt securities or on dividends paid on equity securities?

Secretary REGAN. Let me get some technical advice on that, Senator.

Senator MITCHELL. Well, if you do not have the information now, could we get in writing more complete information?

Secretary REGAN. I would be more than happy to submit that for the record.

[Enclosed is a copy of the letter subsequently sent to all members of the committee.]

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

March 2, 1983

Dear Mr. Chairman:

The purpose of this letter is to respond to the questions raised during my appearance before the Committee on February 3 concerning the revenue estimate for interest and dividend withholding and the current level of under-reporting of interest and dividend income.

The revenue estimate for withholding was derived in the following manner:

The base for the estimate is the amount of unreported interest and dividend income. Excluded from this base (throughout this letter) are interest and dividend payments that are not affected by the withholding rules, such as interest paid by individuals. Based on the Internal Revenue Service's research programs, including the Taxpayer Compliance Measurement Program, it is estimated that, at 1983 levels, $25 billion of interest and dividend income that should be reported on tax returns will not be reported in the absence of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

We wish to make clear that this estimate of the interest and dividend tax gap is based upon conservative assumptions. An estimate based on all payments of interest and dividends and on claimed deductions of interest (the National Income Accounts analysis) by the Bureau of Economic Analysis of the Department of Commerce concludes that the tax gap of unreported interest and dividends is almost twice as large as that estimated by the Treasury Department. We believe, however, that the absence of certainty as to the cause of this discrepancy requires the use of the more conservative estimate of the size of the gap of unreported interest and dividends, rather than the much larger number indicated by the National Income Accounts, or an average of the two numbers.

Approximately 86 percent of all interest and dividend payments -- including most interest paid by banks and thrift institutions -- were subject to information reporting prior to enactment of TEFRA. As mentioned above and based on the

conservative estimating techniques also noted above, the amount of interest and dividend income earned but not reported prior to TEFRA was $25 billion (interest earned but not reported was about $18 billion and unreported dividend income was about $6.5 billion).

For interest payments on bearer obligations and on most Federal obligations, there was no information reporting required prior to TEFRA. For payments not subject to information reporting, the rate of compliance was only about 78 percent. Thus, in the absence of any of the TEFRA provisions 22 percent ($7 billion) of interest on obligations not subject to information reporting would go unreported by taxpayers. Because the amount of payments not subject to information reporting was small compared to the amount of payments for which information reports were required to be filed, the combined rate of compliance for all interest and dividends without the TEFRA provisions is estimated to be about 90 percent, leaving the total gap of $25 billion mentioned above.

A comprehensive system of information reporting will increase the rate of compliance on all payments to 91 percent. Thus, the broadened information reporting introduced by TEFRA will, by itself, only reduce the amount of unreported interest and dividends to $21 billion, still an unacceptable gap.

The withholding provisions in TEFRA reduce the revenue loss from the $21 billion that goes unreported even after the broadened information reporting in TEFRA. The 10 percent withholding on that amount improves compliance by $2.1 billion of additional tax collections at 1983 levels, even if withholding causes no further increase in reporting. (The total revenues raised through 1988 from the improved compliance due to withholding is $13.1 billion.) In fact, compliance will increase more than this amount because some persons who do not now report receipts of interest and dividends (and who would not report such receipts even under the expanded information reporting provided by TEFRA) will be inclined to report and pay tax on the entire payment once such payments are subject to withholding. The amount of induced compliance resulting from this tendency again was conservatively estimated.

It is useful to compare the above figures on noncompliance and unpaid taxes on interest and dividend income with corresponding experience with respect to wages subject to withholding. Not only is the compliance rate on wages significantly higher than that on interest and dividends, but even when wage income is not reported on tax returns, taxes are collected through the existing withholding system. As a result essentially 100 percent of taxes due on wages subject to withholding are collected.

With respect to payments that are currently reported by taxpayers, the new withholding provision will raise a small amount of revenue -- about $0.3 billion -- generated on an annual basis because of an acceleration of tax collections. In addition, in the period immediately after withholding becomes effective, there will be a one-time acceleration of receipts of $3.9 billion. This is because no credits from prior year withholding will offset current withholding receipts in the first year. This acceleration of tax payments required by withholding will treat taxes due on interest and dividends essentially like taxes due on wages. Taxes on all these sources of income will be paid on a timely and fair basis, as the income is earned.

The enclosed table shows the breakout of the three components of the withholding revenue estimate: increased compliance resulting from expanded information reporting, increased compliance from the imposition of withholding, and the acceleration or speedup of tax payments.

I would like also to correct any misleading impression that may have arisen from a 1981 study undertaken by the Internal Revenue Service. Some persons have asserted that this study found a 97 percent rate of compliance for all dividends and interest. That is incorrect. This study was not designed to measure the level of interest and dividend compliance generally. Rather, the study focused on certain limited situations that are not at all representative of the overall compliance problem. Specifically, the study measured noncompliance only in cases meeting each of the following three conditions:

(i) the taxpayer had filed a proper tax return,

(ii) the payor had filed an information return (Form 1099), and

(iii) the information return was readable and contained a proper taxpayer identification number.

Unfortunately, one or more of these conditions are not met in a great many situations. Many taxpayers who should file tax returns do not. Currently, between 5 and 6 million taxpayers fail to file required tax returns. In addition, over 11 percent of information returns for interest and dividends lack a taxpayer identification number, or show an improper number. For taxpayers who file income tax returns on a timely basis, and provide payors with information that enables them to file a proper Form 1099, it is not surprising that voluntary compliance is at a materially higher level than occurs in situations where either a tax return is not properly filed or accurate information is not provided to the payor. As reported above, it is estimated that prior to TEFRA the rate of taxpayer compliance for interest and dividend income of all taxpayers is 90 percent, based on conservative assumptions.

Many have suggested that the compliance levels sought through interest and dividend withholding could be achieved by a vastly enlarged IRS audit program. This is simply not a realistic proposal. An attempt to achieve the compliance levels that will be obtained under withholding would require literally millions of new taxpayer contacts, audits, and legal proceedings. Consequently, attempts to resolve the compliance problem through a stepped-up audit program would be perceived correctly as harrassment. This would seriously damage ongoing efforts to insure honest taxpayers that our tax system is fair and uniformly applied in such a way as to encourage the highest degree of voluntary compliance with the law.

Sincerely,

Donald T. Regan

Donald T. Regan

The Honorable
Robert Dole
Chairman, Senate Finance Committee
Washington, D. C. 20510

Revenue Effect of Withholding on Interest and Dividends
(Including Expanded Information Reporting)

($ billions)

	Fiscal Years						Cumulative total
	1983	1984	1985	1986	1987	1988	(1983-1988)
Reporting (compliance)	0.1	0.4	0.7	0.9	1.2	1.3	4.6
Withholding:							
Interest:							
Speedup	0.7	1.9	0.2	0.2	0.2	0.2	3.4
Compliance	0.2	1.6	1.7	1.7	1.8	1.9	9.0
Total interest	0.9	3.5	1.9	1.9	2.0	2.2	12.4
Dividends:							
Speedup	0.2	1.1	0.1	0.1	0.1	0.1	1.7
Compliance	0.1	0.7	0.8	0.8	0.9	0.9	4.1
Total dividends	0.2	1.8	0.8	0.9	1.0	1.1	5.8
Total:							
Speedup	0.9	3.0	0.3	0.2	0.3	0.4	5.1
Compliance	0.3	2.3	2.4	2.5	2.7	2.9	13.1
Total withholding	1.1	5.3	2.7	2.8	3.0	3.2	18.2
Grand total:							
Speedup	0.9	3.0	0.3	0.2	0.3	0.4	5.1
Compliance	0.4	2.7	3.1	3.5	3.8	4.2	17.7
Total	1.2	5.7	3.4	3.7	4.2	4.5	22.7

Office of the Secretary of the Treasury
Office of Tax Analysis

March 1, 1983

Note: Details may not add to totals due to rounding.

Senator CHAFEE. I wonder, Mr. Chairman, we are all pounded by this and we want the right information back. I wonder, Mr. Chairman, if when the Secretary says that he could not just do it for the record, but mail it to each of the committee members.

Secretary REGAN. I will send to each individual member of this committee a copy of what I am submitting for the record.

Senator CHAFEE. That would be very helpful.

Senator MITCHELL. And as detailed as possible.

Secretary REGAN. I understand what you are driving at.

Senator MITCHELL. Let me say, I served as U.S. attorney for several years and prosecuted a great many tax evasion cases, and I do not believe that, insofar at least as the enforcement of the laws is concerned, that the major area of noncompliance is in interest earned on savings accounts.

It is on dividends and on interest earned on other than savings accounts, and more specifically debt securities. And I think it would be important to all of us to understand that distinction and have the data to support it when we deal with this problem.

The CHAIRMAN. Senator Boren?

Senator BOREN. Mr. Chairman, I very briefly want to associate myself with the remarks that Senator Chafee made earlier, in regard to tuition tax credits, I hope the administration would take that off the agenda this year.

It is divisive and if it is brought forward, I hope it will be after things that need to be dealt with this year, are completed because there will be very prolonged discussion and debate if the vocal cords of a number of us hold out on that subject, including the Senator from Rhode Island and myself.

Also, I hope you will take seriously what has been said about bipartisanship. As I said in my remarks to you a while ago, I am prepared to vote for a freeze approach on domestic spending. I think we have to have it. I am even prepared to vote to freeze COLA's. But I think fairness and equity demand that we have more than just the reduced inflation rate adjustment in defense spending. We have really had no yielding whatsoever on defense spending, and I think fairness demands that we look at the third year of the tax cut for whatever period that we hold down COLA's.

So there are some of us on the Democratic side who are saying that we are ready to vote for a freeze on spending, but we think we cannot look at the $500 a month pension earner and say we are going to freeze you and not look at the upper income person. We think we need a one-boat freeze, not a partial freeze but a genuine freeze that puts us all in the same boat together without regard to income.

I would urge that you and the President very, very seriously consider those on the other side of the aisle who are prepared to support spending restraint, but not to support spending restraint of social programs only and in total isolation. I think it is very, very important. I think we could build a consensus in this Congress very, very rapidly, if there could be some yielding on that point on the part of the administration. And I think there are enough people on this side of the aisle who would go with the spending restraint if there could be that kind of accommodation.

Let me shift gears and ask two very quick questions, one in regard to contingency tax. I agree with what Senator Chafee has said in terms of picking only on oil. That policy distorts the energy mix in the country. I am not only concerned about the consumers; as you might suspect, I am also concerned about what is happening in production right now.

In Oklahoma we had 910 drilling rigs drilling in the State a year ago. We have 348 drilling at the latest report. That is the most catastrophic decline in the drilling rate that we have ever recorded in the history of this country, and it is causing a tremendous dislocation.

We all know about what happened with the Penn Square Bank. When you think that most of those rigs that are stacked were financed with borrowed money at an average cost of $3 or $4 million each at probably 20 percent interest with no cash flow coming in and 120 people directly unemployed on each rig not working, you begin to see what is happening.

With the disarray in the OPEC nations and the uncertainty which is already helping to cause the rapid decline in drilling, I think you realize that the domestic energy industry reacts perhaps even more strongly to the injection of uncertainty into an economic situation than other industries. Just the talk of this contingency tax on domestic oil production, and a tax that might well have to be borne in part by the domestic industry, is causing a grave, grave concern in the domestic producing sectors of the country.

I just wonder if you could assure us that the contingency tax is only viewed as a contingency for the years that have been considered and if you could assure us that the administration and the President would resist the imposition of any $5 tax on domestic oil production either this year or next year? Can you assure us that the earliest we could see that is for the contingency years you have outlined and that it would be opposed very actively by the administration before that period of time?

Secretary REGAN. I can give you the assurance, Senator, that we have absolutely no plans for additional taxes in 1983 or 1984. The oil tax that we have considered will not start if ever, until October 1, 1985.

Senator BOREN. Well, once an idea is placed before the Congress in a year in which there are huge and looming deficits, ideas tend to be picked up. In fact, I saw two Members of the Senate quoted in the New York Times to the effect that since the administration has said we should consider such a tax in the future why not impose it now in light of the deficit.

I guess what I am asking is, if there is any attempt to impose it before 1985, would the administration veto such a proposal if it came from the Congress?

Secretary REGAN. Well, obviously you never commit the President to a veto in advance, but as Secretary of the Treasury I see no need for such a tax at this time.

The CHAIRMAN. A lot of ideas happen without any suggestions, too. I mean, there are a lot of free starters around here.

I just wanted to conclude on a positive note. I understand you would support reducing the holding period from 12 months to 6 months for capital gains?

Secretary REGAN. I think we would support that. I think that actually would be a revenue raiser.

The CHAIRMAN. I think it would, in a year or so. We have had a lot of success on the Senate side, not too much on the House side. But I reserved No. 13 for that bill this year, so it is S. 13, one that I think will be easy to remember, and we hope to enact that legislation before July 1.

Senator CHAFEE. Mr. Chairman, could I ask one quick question, and it will be very quick?

Mr. Secretary, in the high tech hearings that the chairman referred to—and I wish we had a better word than "high tech," but technology for the future that will provide jobs—one of the suggestions was that we might increase the flow of money into venture capital projects by providing that those who held their securities for a longer period would get a reduced capital gains rate.

In other words, perhaps if you held it for 3 or 5 years then you might go to 10 percent. In other words, as you know, Mr. Secretary, better than I do, they are not concerned with a short holding period. They are in for 3 or 5 years.

Does this raise all kinds of problems or do you see——

Secretary REGAN. Well, let us take a look at it. We certainly would be willing to study that.

As you know, there is a companion suggestion concerning the indexing of capital gains. That is another variant on the same type of thing.

Senator CHAFEE. Well, just the mention of indexing spoils it for me, Mr. Secretary. [Laughter.]

Thank you.

The CHAIRMAN. Thank you very much, Mr. Secretary. We appreciate your patience.

The committee is adjourned.

[Whereupon, at 12:10 p.m., the committee was adjourned.]

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